United States Court of Appeals

for the Second Circuit

RESPONDENT'S BRIEF

76-4067

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FOR THE SECOND CIRCUIT

No. 76-4067

ARTHUR LIPPER CORPORATION and
ARTHUR LIPPER, III,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for Review of Orders of the
Securities and Exchange Commission

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

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PRELIMINARY STATEMENT

This appeal is from orders of the Securities and Exchange Commission, entered October 24, 1975 and January 6, 1976, which, among other things, revoked the broker-dealer registration of Arthur Lipper Corporation ("Lipper Corp.") and barred the firm's president and controlling stockholder, Arthur Lipper III, ("Lipper") from future association with any broker or dealer (Doc. 358, R. 3872, A. 455; Doc. 364, R. 3908, A. 458). [1/] The case is a

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1/ References to the record are cited as "Doc. ___, R. ___," indicating the document number and record page number therein to which reference is made as shown in the "Certified List of All Documents, Transcripts, Testimony, Exhibits and Other Material Comprising the Record in the Matter of Arthur Lipper Corporation, et al." filed April 22, 1976. References to the same material in the deferred joint appendix are cited as "A. ___."

further chapter in the extensive litigation spawned by the IOS [2/] financial empire and its creator, Bernard Cornfeld. On May 23, 1967, the events which gave rise to this litigation were set in motion when IOS achieved the distinction of being the only mutual fund complex barred by the Commission from the United States (Doc. 135, R. 1926-35, A. 368-77). [3/] In its heyday during the late 1960's, however, IOS had over $2.5 billion under its control accumulated primarily from small investors, and Mr. Cornfeld had announced plans to multiply that figure to $15 billion during the next decade. [4/] This was understandable, since Mr. Cornfeld had built a $100 million personal fortune from IOS, and approximately 100 of his business associates had similarly become millionaires as a result of their involvement with IOS. [5/] "The only trouble," as one commentary noted, "was that IOS was not a respectable financial institution. It was an international swindle." [6/]

The particular IOS-connected person with which this litigation deals is Arthur Lipper III. After the Commission, in 1967, had expelled IOS and its affiliates from the United States securities markets in consequence of their violations of the federal securities laws, Lipper,

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2/ IOS, Ltd. (SA) is referred to herein as "IOS"; the initials are an acronym for "Investors Overseas Services."

3/ The Commission's administrative proceeding was settled on the basis of a consent order (discussed infra, pp. 10-11) which, among other things, contained IOS's undertaking not to sell securities to United States citizens or nationals, wherever located (Doc. 135, R. 1930, A. 372).

4/ C. Raw, B. Page & G. Hodgson, Do You Sincerely Want To Be Rich? 3-4 (1971)

5/ Id. at 4.

6/ Id.

at IOS's inducement, and with the aid of a subsequent financial guarantee (see note 14 *infra*), formed Lipper Corp. 7/ as a tool with which IOS could continue to participate in the American markets. The fraudulent conduct on which the Commission based the proceeding from which this appeal arises was one result of the IOS/Lipper alliance. 8/

In entering the orders presently before this Court for review, the Commission, affirming the findings of the administrative law judge, found that Lipper and Lipper Corp. had engaged in a course of conduct which aided and abetted a fraudulent scheme whereby IOS, in its capacity as the investment adviser to a complex of mutual funds, defrauded the mutual funds and their shareholders. IOS accomplished this breach of its fiduciary obligations to the funds' shareholders by diverting to itself, with active assistance from, and through the facilities of, Lipper Corp., over $1,450,000 which, as the Commission stated, "in equity and good conscience" belonged to the shareholders of the mutual funds (Doc. 358, R. 3847, A. 427).

7/ Lipper and Lipper Corp. are sometimes referred to herein as "petitioners."

8/ Another consequence of this alliance resulted in the filing of an action by the Commission in the Southern District of New York seeking to enjoin IOS, Lipper Corp. and various IOS affiliates from further violations of the registration requirements of the Securities Act of 1933. *Securities and Exchange Commission v. IOS, Ltd. (S.A.), et al.*, 69 Civ. 3594 (S.D.N.Y., filed Aug. 14, 1969). The complaint alleged that, from April 1968 through March 1969, the IOS defendants had caused mutual funds affiliated with IOS to purchase shares of a Canadian corporation, Revenue Properties Co., Ltd., which Lipper Corp. then sold to investors in the United States, but wthout benefit of registration under the Securities Act. Simultaneously with the filing of the complaint, the IOS defendants consented to the entry of a permanent injunction barring them from further violations of Section 5(a) and (c) of the Securities Act, 15 U.S.C. 77e(a) and (c). On July 24, 1973, Lipper Corp. consented to the entry of findings and conclusions describing its violations, and entered into an undertaking, expressly enforcible by contempt, to refrain from further violations of Section 5(a), (c).

Lipper Corp. made this diversion possible by charging the IOS controlled funds excessive commissions for executing the funds' securities transactions in the United States over-the-counter securities markets 9/ and then surrendering to an IOS subsidiary, Investors Planning Corporation of America ("IPC") 50 percent of that commission (IOS later demanded a retroactive increase to 60%). The funds' shareholders -- including citizens of the United States -- derived no benefit from these payments to IOS, nor were they ever specifically informed of their existence. IOS, on the other hand, utilized the cash so received to transform its subsidiary, IPC, an American broker-dealer registered with the Commission under the Securities Exchange Act, from a failing business into a financially attractive and saleable entity. 10/ Principals of IOS had suggested that Arthur Lipper form Lipper Corp. with the expectation of his funnelling these payments to IOS and subsequently assisted Mr. Lipper in obtaining additional financing.

9/ "Transactions in securities not taking place on an exchange are referred to as over-the-counter transactions. The over-the-counter markets, unlike the exchanges, have no centralized place for trading . . . . [A]ll registered broker-dealers are entitled to participate. The broker-dealers vary in size, experience and function; the securities differ in price, quality and activity."

Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. Pt. 2 at 541 (1963).

10/ As discussed further (p. 18, *infra*), IPC was eventually sold by IOS to Equity Funding Corporation of America.

In considering the sanctions which petitioners' involvement in this scheme merited, the Commission's administrative law judge found that Mr. Lipper had done:

> "nothing to ameliorate [the] fraudulent practice until his own and [Lipper Corp.'s] financial success were assured. The picture that emerges from the record is of a man intent on personal gain and willing to take the risk that the scheme by which he could reach his goal would not be found illegal." (Doc. 286, R. 3075-76; A. 420-21).

The Commission concurred in this finding. (Doc. 358, R. 3869.1, A. 452). On that basis, and considering both the likelihood that petitioners might, if unchecked, engage in further violations of the law and the Commission's obligations to deter similar misconduct on the part of other registered broker-dealers, the Commission determined that expulsion of both petitioners from the securities industry was appropriate in protection of the public interest.

COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

1. Did a registered securities broker aid and abet violations of antifraud provisions of the Securities Exchange Act where the broker, which was created at the behest of an investment adviser to a group of mutual funds, participated in a prearranged scheme with the adviser to obtain cash from the mutual funds by charging excessive commissions for executing the funds' over-the-counter portfolio transactions and funnelling back 50 percent of those excessive commissions to an affiliate of the adviser?

2. Did the Commission properly reject, as irrelevant, certain commission-sharing practices which were then tolerated upon exchanges, which practices were urged by the broker in justification of the conduct

described in Question 1, where such practices were illegal in the over-the-counter market and where, in any event, the broker's conduct aided and abetted a breach of fiduciary duty irrespective of where it had occurred?

3. Did the Commission have jurisdiction to exercise its regulatory authority over a broker for the conduct described in Question 1, where the mutual funds were defrauded by payments (a) made in the United States; (b) between one American registered broker and another American registered broker; (c) in connection with the purchase of securities of American companies; (d) in the American over-the-counter market; and (e) 3,000 Americans held shares in one of the funds -- notwithstanding that the majority of shareholders in the funds were foreigners?

4. When the Securities and Exchange Commission, on independent review and evaluation of the record in an administrative proceeding, found, on the basis of substantial evidence in the record, serious and willful violations of law by a broker and the person who was its founder, president and principal shareholder, and imposed sanctions authorized by statute on each of them, is its order subject to reversal because --

-- (a) the broker allegedly relied on advice of counsel, where counsel, who had been counsel to the adviser and was at the time a director of one of the funds, had advised

that it was the view of the Commission's staff that the activities were illegal (although counsel disagreed with that view);

-- (b) the Commission did not also proceed against other brokers who were alleged to have shared part of their commissions with the adviser's affiliate (although not pursuant to any scheme);

-- (c) the sanctions imposed by the Commission against them were more stringent than the sanctions that would have been imposed by the administrative law judge; and

-- (d) Commissioners who had been members of the Commission at the time of oral argument participated in the Commission's unanimous decision on the basis of their review of the record (including a transcript of the oral argument), where the broker's motion for new argument did not point to any specific prejudice and was not made until after the Commission's decision had been rendered?

STATUTES AND RULES INVOLVED

Sections 10(b) and 30(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) and 78dd(b), and Securities Exchange Act Rule 10b-5, 17 CFR 240.10b-5, are set forth in petitioners' brief at pps. 4-6. 11/

COUNTERSTATEMENT OF THE CASE

As noted, Lipper and Lipper Corp. seek review of Commission orders which barred them both from the securities business. This Court's jurisdiction rests on Section 25(a)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78y(a)(1), which provides for review of any final Commission order, at the request of any person aggrieved, in the United States Court of Appeals for the circuit in which the petitioner resides.

The IOS Financial Empire And Its Need For An Ally In The American Securities Industry

The genesis of the Lipper Corp. and its role in aiding IOS's scheme to defraud the shareholders of IOS-affiliated mutual funds lies in conditions which faced IOS and its subsidiaries during the late 1960's. IOS was a Panamanian corporation with its principal office in Geneva, Switzerland. Bernard Cornfeld was the president, and Edward Cowett the executive vice-president, of IOS during the period in question; each also was an IOS director and held various positions in IOS subsidiaries. IOS was registered with the Commission as a broker-dealer under the Securities Exchange Act,

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11/ Pages in petitioners' brief will be cited as "Pet. Br. __."

but acted primarily as a holding company with numerous subsidiaries which, during 1967 and 1968, were principally engaged in the sale of the shares of, and the furnishing of management services to, certain non-United States based investment companies commonly known as mutual funds. These mutual funds were Fund of Funds, Ltd. (hereinafter "FOF"), a Canadian corporation, which invested chiefly in United States mutual funds;[12/] IIT, an International Investment Trust (hereinafter "IIT"), an investment trust organized under the laws of Luxembourg, which invested in companies throughout the world; and Regent Fund Ltd. (hereinafter "Regent"), a Canadian investment company with investments in both Canada and the United States. The funds operated under IOS's complete control: the investment adviser to each fund -- the entity with the power to make the day-to-day investment decisions for the funds -- was itself an IOS subsidiary. The shares of these IOS-affiliated funds were distributed world-wide, although such sales as were made to United States citizens were unlawful. As described <u>infra</u>, p. 10-11, the Commission had expressly prohibited IOS and its affiliates from making sales in the United States or to United States citizens after May 23, 1967 (Doc. 1, R. 424-40; Doc. 95, R. 1836-41; Doc. 135, R. 1926-35, A. 368-77).

The IOS complex also included IPC, a Delaware corporation, which, as noted above, was registered with the Commission as a securities broker-dealer. IPC was a member of the National Association of Secu-

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12/ FOF owned all of the shares of yet another investment company, FOF Proprietary Fund, Ltd., ("FOF Prop."). (Doc. 1, R. 839)

rities Dealers, Inc., ("NASD"), an industry self-regulatory organization, and maintained its principal place of business in New York City. (Doc. 40, R. 1770; Doc. 137, R. 1982; Doc. 211, R. 2576; Doc. 365, R. 3909). IOS knew at the time of its acquisition of IPC in 1965 that the firm was not a profitable operation and would require immedite infusions of capital. IOS nevertheless purchased IPC because it wished to acquire an American brokerage firm selling mutual funds shares in order to create an American outlet for the shares of the IOS-affiliated funds (Doc. 1, R. 445-50). Although IPC had suffered an operating losses during both the last four months of 1965, and for the entire year of 1966, IOS was confident that it could turn IPC into a profitable operation within three years (Doc. 1, R. 530, 599, A. 72, 97).

IOS's plans for IPC were disrupted when, in February, 1966, the Commission instituted public administrative proceedings against IOS and certain of its affiliates (Doc. 134, R. 1906-25, A. 348-67). These proceedings were based on allegations that shares of the purportedly foreign IOS mutual funds had, in fact, been offered and sold to an appreciable number of Americans fraudulently and in violation of various provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Ultimately, on May 23, 1967, these proceedings were settled on the basis of IOS's undertaking to:

1. Divest itself of IPC within a specified time;

2. Cease selling, with limited exceptions, securities to United States citizens and nationals wherever located; 13/

3. Make a rescission offer to Americans who held interests in FOF;

4. Withdraw its own broker-dealer registration and the registrations of those of its affiliates (except IPC) which were then registered with the Commission; and

5. Conduct all its securities activities outside the United States. (Doc. 135, R. 1926-35, A. 368-77).

One effect of this settlement was to prevent IOS and its affiliated funds from placing orders for portfolio transactions with securities brokers or dealers located in the United States (Doc. 1, R. 464-67, 1016-17, 1027-28, A. 40-43, 251-52, 262-63); Doc. 135, R. 1926-35, A. 368-77). IOS was, therefore, confronted with two immediate problems: improving the profit potential of IPC's operations in order to permit it to sell IPC profitably; and devising a method by which mutual funds under its control could continue to execute portfolio transactions in the American securities markets notwithstanding the terms of the Commission's settlement order (Doc. 1, R. 464-68, 530-31, A. 40-44, 72-73). In order to resolve these problems in a manner designed to insure the greatest profit to IOS, IOS turned to Lipper.

The Creation of Arthur Lipper Corporation

After preliminary discussions during early 1967, Lipper and Cowett conceived a scheme designed to solve both of the problems facing IOS. Prior to April, 1967, Lipper was the partner responsible

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13/ Sales outside the United States to IOS employees, sales by IPC, and sales by Pension Life Insurance Company of America were permitted (Doc. 135, R. 1930, A. 372).

for the institutional clients of Zuckerman, Smith & Co., a registered New York broker-dealer. Zuckerman, Smith & Co., as a result of Lipper's efforts, was one of IOS's primary United States brokers and, by 1966 IOS business represented 75 to 80 percent of all Zuckerman, Smith & Co.'s institutional business. (Doc. 1, R. 826-28, 896-99, A. 150-52, 203-04). Lipper agreed to form a new firm, Lipper Corp., which would be registered as a broker-dealer with the Commission. 14/ Lipper Corp. agreed to main tain offices in New York, London, and Geneva. 15/ As previously stated, portfolio transactions in the American securities markets on behalf of IOS and its affiliated funds were not possible unless the orders were placed outside the United States. Accordingly, Cowett and Lipper createo an elaborately convoluted system to bypass the prohibition against IOS using American-based brokers (Doc. 1, R. 465-69, 903-05, 1016-18, A. 41-45, 208-09, 251-53). 16/

14/ IOS aided Lipper in raising the capital necessary for the maintenance of Lipper Corp. and its elaborate communications system. Lipper Corp. found it impossible to obtain its required funds from independent sources because of the firm's heavy dependence on the IOS account (Doc. 1, R. 888-89, A. 195-96). In the late fall of 1967, IOS and Lipper worked out an arrangement whereby IOS guaranteed a $500,000 loan made to Michael Lipper, Arthur Lipper's brother (Doc. 1, R. 469-72, 888-90, A. 45-48,195-97). Michael, in turn, loaned the money to Lipper Corp. (Id.) In mid-1968, the amount of this loan (and the IOS guarantee) was increased to one million dollars (Doc. 1, R. 472, 643-44, 890-91, A. 48, 124-25, 197-98). The loan was not repaid until November, 1969, subsequent to the commencement of the Commission's administrative proceeding (Doc. 1, R. 891, A. 198).

15/ Mr. Cowett had intially suggested that Zuckerman, Smith & Co. open overseas offices to serve as IOS's contact with the American securities market. The partners of Zuckerman, Smith declined, however, to participate in Mr. Cowett's plans (Doc. 1, R. 465, A. 41).

16/ Under the system which Cowett and Lipper designed, a portfolio transaction for one of the IOS-affiliated funds was executed in the follow-

(footnote continued)

IOS and Lipper saw in the creation of Lipper Corp. and the establishment of the elaborate communications network [17/] an opportunity also to accomplish the second of IOS objectives -- immediate infusion of cash into IOS's subsidiary, IPC: Cowett, in accordance with his previous arrangements with Lipper, instructed Lipper Corp. that 50 percent of the commissions these mutual funds paid to Lipper Corp.

16/ (footnote continued)

ing manner: IOS engaged various American investment advisers to make recommendations concerning fund portfolio transactions in the American securities markets. These American-based sub-advisers would transmit recommendations to purchase or sell specific securities in the American market to Lipper Corp. in New York City, which would relay that request to Lipper Corp. in London. The Lipper Corp. office in London would then forward the request of the United States sub-adviser to the London & Dominion Trust Company which occupied the office adjacent to Lipper Corp. in London. London & Dominion Trust Company, in turn, would relay the request to IOS's office in Geneva, Switzerland. IOS, which in most instances routinely approved the recommendations of its American-based sub-advisers, would transmit its decision back to the London & Dominion Trust Company's office. On receipt of this approval, London & Dominion Trust Company would make up an order ticket which would, in turn, be physically delivered next door to Lipper Corp.'s London office. Lipper-London would then transmit the order to Lipper-New York for execution in the United States market. (Doc. 1, R. 473-74, 840-42, 1017-18, A. 49-50, 252-53).

As intricate as the system may have been, Conwill, Lipper's and IOS's counsel, testified that this entire process could be performed in approximately the length of time required to describe it orally (Doc. 1, R. 1018, A. 253).

17/ The communications network which Messrs. Lipper and Cowett designed consisted of: (1) a direct telephone line, connected with the IOS switchboard in Geneva, from Lipper-New York to Lipper-Geneva; (2) direct telephone lines connecting Lipper-New York with Lipper-London and Lipper-London with Lipper-Geneva; (3) direct telephone lines between IOS's Geneva office and the London & Dominion Trust Company in London. All the telephone lines were equipped with facsimile equipment permitting the reproduction and transmission of records overseas. Several telex lines also served the various offices in the communications network; these telex lines operated independently of the telephone lines (Doc. 1, R. 481-82, 640, A. 57-58, 121-22).

were to be funnelled to IPC (Doc. 10-15, R. 1655-60; Doc. 1, R. 563-64, 857, A. 74-75, 170).[18/]

In order for petitioners to pay these kickbacks and still cover their costs of operation and extract a profit, it was, of course, necessary for Lipper Corp. to charge the funds a substantial commission. Cowett and Lipper selected as the rate which Lipper Corp. would charge IOS affiliates for their over-the-counter business the minimum commission rate which the New York Stock Exchange ("the Exchange") required its members to charge for transactions executed on the Exchange.[19/] Lipper knew that this rate would provide him with adequate compensation for his services while permitting the kickback of 50 percent of the charge to IOS's subsidiary, IPC (Doc. 1, R. 566, 855-56, 869-71, 944-45, A. 76-77, 168-69, 182-84, 220-21).

As spelled out at pp. 31-37 infra, there was, however, no Commission or Exchange requirement that, when executing transactions in the over-the-counter market, an Exchange member charge a rate equivalent to the minimum commission (Doc. 1, R. 1088-89, A. 323-24). The Exchange did not to have any authority over commission charges in the over-the-counter market, and was only concerned with the rate its members were charging

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18/ Mr. Cowett, in his capacity as officer of the management companies which made investment decisions for the mutual funds, would direct that the portfolio transactions for those funds be placed with Lipper Corp., which would charge a commission in executing these transactions (Doc. 1, R. 548-50, 563-64, A. 74-75).

19/ Fixed minimum rates of commission subsequently were abolished. See p. 38, n.53, infra.

on over-the-counter transactions if these rates did not cover the cost of the transaction because below-cost rates might represent an indirect rebate of charges made to the same customers for Exchange transactions in violation of the Exchange's anti-rebate rule (Doc. 1, R. 1088-90, A. 323-25).

During the period involved in this case, from April, 1967, through August, 1968, petitioners and their affiliates never met with Exchange personnel to ascertain whether Lipper Corp. might permissibly charge less than the Exchange's commission rate for executing portfolio transactions in the over-the-counter market (Doc. 1, R. 948-50, A. 224-26). Nor were petitioners ever told by anyone at the Exchange that Lipper Corp. could not execute transactions in the over-the-counter market at less than the Exchange's minimum commission rate (Doc. 1, R. 948-52, A. 224-26).[20/]

20/ Mr. Conwill, Lipper's counsel, did state that, during early 1967, Mr. Bishop of the Exchange informed Conwill that the "appropriate charge" for an Exchange member's over-the-counter business was the Exchange minimum rate. (Doc. 1, R. 1006-07, A. 241-42). Mr. Bishop testified that the Exchange had "no position" on member firms' over-the-counter charges and no authority to establish such rates (Doc. 1. R. 1088-89, A. 323-24).

In addition, the NASD had no requirement compelling or suggesting that a member charge any particular rate on over-the-counter business. Indeed, the law specifically prohibits the NASD from fixing any schedule of prices or rates of compensation or other charges. See Section 15A(b)(6), of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3(b)(6); prior to the Securities Acts Amendments of 1975, Public Law 94-29 (June 4, 1975), this prohibition appeared in Section 15A(b)(8). In any event, Lipper and Conwill, IOS's and Lipper's counsel, made no inquiry of the NASD to determine its view concerning this subject (Doc. 1, R. 1052-53, A. 287-88).

Likewise, neither Lipper nor Conwill, IOS's counsel as well as Lipper's, sought advice from the Commission or its staff as to the rate that Lipper Corp. could charge a customer for executing portfolio transactions in the over-the-counter market (Doc. 1, R. 947-48, A. 223-24). They had good reason to avoid such an inquiry. In testimony in this proceeding, Conwill candidly admitted that, as a former Commission General Counsel, he knew that the Commission's staff would never have tolerated the "giving-up" 21/ of over-the-counter commissions in the manner contemplated under the IOS/Lipper kickback arrangement and that the Commission itself had characterized over-the-counter give-ups as illegal. (Doc. 1, R. 1012-14, 1053-55, A. 247-49, 288-90). Conwill admitted that he had advised Lipper of the Commission's position -- that give-up payments on over-the-counter business were unlawful -- but opined that he personally believed that the Commission staff was in error and that the contrary public statements of the Commission and its staff were nonbinding. (Id.)

The IOS/Lipper Scheme In Operation

In April, 1967, Lipper Corp. commenced operations as IOS's link with the United States securities markets. During the period from July 10, 1967, through the end of August, 1968, petitioners, in response

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21/ "Give-up" was the industry term for the payment of a portion of a broker's commission to a second broker who was uninvolved in the transaction on which the commission was earned. The practice arose on the Exchange, where members were required to charge a fixed rate of commission regardless of the cost of executing the transaction. the precondition for this practice -- mandatory fixed rates of commissions -- never existed in the over-the-counter market. See generally Securities and Exchange Commission, Report to Congress on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966) at 162-63, 169-72 (hereinafter "Public Policy Report").

to orders from IOS, remitted to IOS's subsidiary, IPC, $1,450,517 (Doc. 1, R. 857-62, 983-85, A. 170-75, 230-32; Doc. 195-201, R. 2461-2515) Of this amount, $1,275,517 represented a 50 percent kickback of the over-the-counter commissions which Lipper Corp., as agent, had charged the shareholders of the IOS-affiliated funds, FOF Prop., IIT, and Regent (Id., Doc. 1, R. 984, A.231). The remaining $175,000 of the $1,450,517 channeled to IPC was remitted on August 28, 1968, when Cowett demanded that petitioners' give-up percentage be retroactively increased from 50 percent to approximately 60 percent (Doc. 1, R. 573-76, 860-62, A. 84-87, 173-75).[22/] As the Commission noted in its opinion: "In view of IOS's relationship to IPC,[[23]/] that money was for all practical purposes given up to IOS" (Doc. 358, R. 3852, A. 432).

22/ As noted, IPC was a subsidiary of IOS. Moreover, both Lipper personally, and Lipper Corp. were enmeshed in various facets of the IOS operations, in addition to the portfolio transactions executed by Lipper Corp. for the IOS-related mutual funds. Lipper served as a director and president of Financial Institutions Growth Fund, Inc. and as a director of Fund of Funds Sterling, Ltd., two IOS-affiliated funds (Doc. 1, R. 454-56, 885-86, A. 37-39, 192-93). Lipper Corp. also aided IOS in locating investment advisers for the various IOS-affiliated funds, took part in portfolio strategy discussions with IOS personnel, prepared the daily printouts of portfolio transactions involving IOS-affiliated funds and, in general acted as a central clearing house in the United States for IOS and its subsidiaries (Doc. 1, R. 473-77, 538, 638, 845-49, 867, 909, 931-35, A. 49-53, 119, 160-62, 180).

23/ The full amount of this retroactive increase would have require an immediate $350,000 payment from petitioners to IPC. Cowett apparently believed that such a payment was necessary in order to consummate the sale of IPC to Volk Technical Corporation (Doc. 1, R. 567-75, A. 78-86). Lipper Corp. paid over the first $175,000 (Doc. 1, R. 861-62, A. 174-75). Cowett apparently never pursued the question of the remaining $175,000 because the negotiations for the sale of IPC to Volk Technical Corporation collapsed (Doc. 1, R. 668).

During fiscal 1966 (before the formation of Lipper Corp.), IPC had suffered an operating loss of $151,949.[24/] For the fiscal year 1967, IPC received approximately $385,000 as a result of give-ups from Lipper Corp. and had after-tax profits of approximately $900,000 (Doc. 1, R. 582-84; Doc. 197, R. 2480). In late 1968, IOS was able to sell the assets of IPC to Equity Funding Corporation of America for $9,400,000.[25/]

The IOS/Lipper scheme was also successful from petitioners' viewpoint. Between May 1, 1967, and June 30, 1968, Lipper Corp. received $11,371,883.75 in gross commissions. Of this amount, $8,014,050.95, or approximately 70 percent, resulted from transactions on behalf of IOS-affiliated funds (Doc. 188, R. 2424).[26/] By July 31, 1970, Lipper Corp. had a net worth of $14 million (Doc. 1, R. 823-24, A. 147-48).

24/ SEC Public Official File No. 811-1251-2, Exhibit B to Financial Statement for IPC as of December 31, 1966.

25/ Doc. 1, R. 603-04, A. 101-02; SEC Public Official File Nos. 8-12374-1, 811-1228-2, pp. 3-4 of the Proxy Material filed on March 20, 1969 and pp. 1, 12 of Exhibit 5 to Form N-1R filed on May 28, 1970.

26/ In 1967, approximately 40 percent of IOS's total commission business paid throughout the world was paid to Lipper and Lipper Corp. This amounted to a monthly income to Lipper Corp. of between $329,000 and $800,000, depending on the trading activity in which IOS's fund management subsidiaries caused the IOS-affiliated funds to engage (Doc. 1, R. 479-81, A. 55-57). In 1967, approximately 80-85 percent of Lipper Corp.'s commission income came directly from IOS and its affiliated funds. In 1968 and 1969 that portion of Lipper Corp.'s commission income which was derived form IOS and its affiliated funds was approximately 70 percent (_Id._; Doc. 1, R. 835, A. 159).

The profits which accrued to petitioners, as a consequence of the high rate of commissions they charged the IOS-affiliated funds, were so great that they became a source of embarrassment even to Lipper. In the fall of 1967, Lipper confided to Cowett that his profits were "exorbitant" and "unconscionably high," even after the payment of a 50 percent give-up to IOS (Doc. 1, R. 637-39, 869-70, 943-45, A. 118-120, 182-83, 219-221). This situation inspired Lipper to offer to perform additional services for IOS (Id.). Petitioners did not, however, volunteer to return a portion of their "exorbitant profits" to the source of those profits -- the shareholders of the IOS-affiliated funds 27/ -- nor did petitioners offer to execute future

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27/ The public shareholders of FOF, IIT, and Regent were never informed of the arrangements between IOS and petitioners (Doc. 1, R. 594-99, 608-11, A. 88-97, 106-09). Neither were the shareholders informed of possible alternative arrangements -- such as the simple expedient of employing a broker which charged rates commensurate with its costs.

Similarly, there was no disclosure to the board of directors of IIT and Regent of the pattern of kickbacks to the board of directors of IIT and Regent, although some of the individual board members may have been aware of certain of the events involved (Doc. 1, R. 649-52, A. 130-33). The FOF board did know of these arrangements (Doc. 1, R. 593-95, A. 91-95). Conwill advised the FOF board, of which he was a member, that there was no way that the fund could benefit from these monies (Doc. 1, R. 1021-22, 1066-71, 1074, A. 256-57, 301-06, 309). Conwill conceded that the Commission and its staff had stated that over-the-counter give-ups were illegal, but assured the FOF board that he personally believed the Commission was wrong. On this basis, Conwill advised the board of directors to ignore the pronouncements of the Commission and its staff on this subject and proceed instead on the basis of Conwill's personal views (Id.) The board was never told that FOF could have benefited by negotiating the execution of the portfolio transactions at a reduced commission rate, by requiring that its transactions be executed on a principal basis, or by insisting that IOS reduce its advisory fees by the amount of the give-ups its subsidiary, IPC, received (Id.).

transactions in the over-the-counter market for those funds at a lesser commission (Doc. 1, R. 638-40, 870-74, 943-45, A. 119-121, 183-87, 219-221). As described above (p. 17), in August, 1968, IOS endeavored to accommodate Lipper in his desire to moderate his profits by demanding a retroactive 10 percent increase in the give-up percentage. As noted, Lipper met this proposal only halfway.

Proceedings Before the Commission

On September 18, 1969, the Commission entered an order instituting administrative proceedings pursuant to Sections 15(b) and 15A and former Section 19(a)(3) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b), 78o-3, and 78s(a)(3), to determine, among other things, whether Lipper Corp. and Lipper had willfully violated and willfully aided and abetted violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5, and, if so, whether remedial action was necessary. The order alleged that, from about July 10, 1967, to about August 5, 1968, petitioners had violated the statute and rule in question by:

(1) entering into an arrangement with the management of FOF Prop., IIT, and Regent whereby petitioners paid to IPC a portion of the commissions charged to the funds for the execution of over-the-counter portfolio transactions;

(2) paying such give-ups to IPC as a result of the arrangement in (1);

(3) engaging in a course of conduct designed to obtain assets from the funds and divert those assets to IPC; and

(4) failing to disclose to the funds and their shareholders the facts set forth in (1)-(3) (Doc. 211, R. 2576-79).

Petitioners filed an answer which admitted the payments to IPC, but denied that this conduct constituted a violation or that petitioners had any duty to disclose their actions to shareholders of the investment companies (Doc. 214, R. 2582-95).

A lengthy evidentiary proceeding before a Commission administrative law judge ensued, throughout which petitioners appeared and were represented by counsel. On June 11, 1971, the administrative law judge filed his initial decision, concluding that petitioners "wilfully violated and wilfully aided and abetted violations of Section 10(b) . . . and Rule 10b-5 thereunder" (Doc. 286, R. 3067, A. 412). This decision was premised, in part, on findings that:

> "[Petitioners'] acquiescence and participation in give-up arrangements which drained from and wasted nearly $1,500,000 of the assets of the IOS-related funds constituted participation with Cowett in a scheme to defraud and in a practice which operated as a fraud and deceit upon FOF, FOF Prop., IIT, and Regent Fund, and their shareholders . . . . [Petitioners'] participation in Cowett's scheme was in derogation of [Lipper Corp.'s] fiduciary responsibility to deal fairly with its IOS fund customers. Those funds and not IPC should have received the benefit of [petitioners'] willingness to execute the funds' transactions at 50 percent of the commission actually charged the funds." (Doc. 286, R. 3065, A. 410)

In considering the sanctions which petitioners' misconduct warranted, the administrative law judge noted that petitioners' violations "were serious and long continuing" (Doc. 286, R. 3075, A. 420), and that Mr. Lipper's behavior evinced both greed and a willingness to gamble on the legality of his chosen method of enrichment. [28/] Never-

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28/ Doc. 286, R. 3075-76, A. 420-21. The administrative law judge's findings in this regard are quoted at p. 5, *supra*.

theless, the administrative law judge determined to suspend Lipper Corp. from effecting over-the-counter transactions for one year and to suspend Lipper from association with any broker or dealer for a similar period (Doc. 286, R. 3077, A. 422).

Lipper and Lipper Corp. petitioned the Commission for review of the administrative law judge's initial decision, and the staff of the Commission cross-petitioned for review of the sanctions imposed. The matter was fully briefed and oral argument heard. On October 24, 1975, the Commission entered an order and opinion (Doc. 358, R. 3844-72, A. 424-55) affirming the administrative law judge's findings and his conclusions. The Commission, however, also determined that his proposed sanctions were insufficient:

> "We cannot be as sanguine as the administrative law judge about future derelictions of this sort by [petitioners]. What we have before us is not some isolated indiscretion. Lipper Corp. owed its existence to IOS. And the Lipper-IOS relationship was rooted in the over-the-counter give-ups that flowed from Lipper to IPC . . . . We think the likelihood of future misconduct by [petitioners]sufficient to call for their exclusion from the securities business. Moreover, . . . that sanction will have a deterrent effect on other broker-dealers who may be inclined to participate in the fraudulent schemes concocted by investment company managers." (Doc. 358, R. 3870, A. 453)(footnotes omitted).

On this basis, the Commission ordered Lipper Corp.'s broker-dealer registration revoked and barred Lipper from further association with any broker-dealer. After the denial of petitioners' request for rehearing, described at pps. 66-68 <u>infra</u>, Lipper Corp. and Lipper filed their

petition for review by this Court of the Commission's orders. 29/

29/ On the same date that the Commission instituted administrative proceedings against Lipper Corp. and Lipper, an order also issued commencing proceedings against IOS, Bernard Cornfeld, Edward Cowett, IPC, and two IPC officers, Raymond Grant and Robert Sutner (Doc. 365, R. 3900-22). On July 7, 1970, the Commission ordered these proceedings consolidated with those instituted against the petitioners. Consolidated evidentiary hearings were held, but, because offers of settlement by the IOS respondents were submitted for Commission consideration after the close of the hearings, post-hearing procedures with respect to the IOS respondents were held in abeyance. Thus, the administrative law judge's decision discussed herein dealt only with Lipper Corp. and Lipper.

In March, 1971, the Commission issued an order imposing remedial sanctions against Bernard Cornfeld, Edward M. Cowett, Raymond Grant and Robert F. Sutner, four of the six IOS respondents. (Doc. 265, R. 2864-66). On March 14, 1972, the administrative law judge issued his initial decision imposing remedial sanctions against the remaining two respondents, IOS and IPC. IOS and IPC sought Commission review, and the Commission's opinion of October 24, 1975, disposes of the review petitions of IOS and IPC in addition to those of the Lipper respondents. In that opinion, the Commission ordered IOS barred from association with any broker-dealer but discontinued proceedings against IPC in light of the fact that the firm had come under the ownership of persons unaffiliated with IOS. Judicial review has not been sought from the Commission's order barring IOS from the securities industry.

ARGUMENT

This Court has observed that "Congress committed to the Commission the responsibility of supervising the activity of broker-dealers" in order that it may guard against the exploitation by the unscrupulous of "the availability of opportunities where those in a position of trust can manipulate others to their own advantage." Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 595 (C.A. 2, 1969). Pursuant to this obligation, in the present case, the Commission confronted evidence that Lipper, "a man intent on personal gain" (Doc. 286, R. 3076, A. 421) voluntarily enmeshed himself in IOS's plans to enrich its American subsidiary, IPC, out of assets belonging to the shareholders who had entrusted their money to mutual funds affiliated with IOS. Petitioners do not deny their participation in this scheme.

Petitioners raise a series of technical and disingenuous arguments aimed at showing that they played out their role in this fraud hoping it to be beyond the Commission's reach; that, as their victims were mainly aliens, "the Commission should not concern itself" (Pet. Br. 47) with their unprofessional conduct, and that the proceedings by which the Commission sought to protect the public from further injury at petitioners' hands were prodecurally imperfect. Although, as discussed below, these contentions are without merit, more significant is the fact that each ignores the more fundamental issue with which the Commission was required to deal in this proceeding. That issue was whether, in view of petitioners' willing role in IOS's fraud, the proper protection of the investing public could tolerate Lipper's or Lipper Corp.'s further enjoyment of the "privilege

of being employed in the securities industry." Hanly, supra, 415 F. 2d at 595 (emphasis in original). In resolving this issue, the Commission concluded that it "would be incompatible with the public interest" for Lipper and Lipper Corp. to continue in the brokerage business, and found itself "constrained to take appropriate preventive action." (Doc. 358, R. 3870, n. 72, A. 453)

I. PETITIONERS' PARTICIPATION IN IOS'S SCHEME TO DEFRAUD ITS AFFILIATED MUTUAL FUNDS BY CHANNELING TO IPC 50 PERCENT OF THE BROKERAGE COMMISSIONS CHARGED ON OVER-THE-COUNTER PORTFOLIO TRANSACTIONS AIDED AND ABETTED VIOLATIONS OF THE FEDERAL SECURITIES LAWS AND MERITED REMEDIAL SANCTIONS

As the Commission observed, "no extended discussion is required to demonstrate" that IOS's diversion of over $1.4 million of the funds' assets to itself "was a gross breach of fiduciary duty" (Doc. 358, R. 3853; A. 433). IOS, as the parent and controlling force behind the investment advisers to the funds, owed a fiduciary duty to the funds and their shareholders requiring "[n]ot honesty alone, but the punctilio of an honor the most sensitive." Rosenfeld v. Black, 445 F. 2d 1337, 1344 (C.A. 2, 1971), certiorari dismissed sub nom. Lazard Freres & Co. v. Rosenfeld, 409 U.S. 802 (1972), quoting Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, J.). 30/

30/ That the investment adviser to a mutual fund is a fiduciary is well-established. See Fogel v. Chestnutt, CCH Fed. Sec. L. Rep. ¶95,393 at 98,992-93 (C.A. 2, Dec. 30, 1975), petition for certiorari filed May 14, 1976, U.S. Sup. Ct. No. 75-1665, 44 U.S.L.W. 3743; Moses v. Burgin, 445 F. 2d 369 373-74 (C.A. 1), certiorari denied, 404 U.S. 994 (1971); Brown v. Bullock, 194 F. Supp. 207, 229 (S.D.N.Y.), aff'd, 294 F. 2d 415 (C.A. 2, 1961); Provident Management Corporation, 44 SEC 442, 447 (1970); Consumer-Investor Planning Corporation, 43 SEC 1096, 1100, n. 7 (1969); Delaware Management Co., Inc., 43 SEC 392, 395-96 (1967). See also Sections 17 and 36 of the Investment Company Act of 1940, 15 U.S.C. 80a-17 and 80a-35.

In violation of this fiduciary obligation, IOS, aided and abetted by petitioners, first devised and then executed a plan whereby half the brokerage commissions which Lipper Corp. charged the funds for executing portfolio transactions in the American over-the-counter market were siphoned off to IPC, and in effect, to IOS itself. As the Commission noted, this type of "'disregard of trust relationship by those whom the law should regard as fiduciaries' was one of the evils that the Exchange Act sought to eliminate." 31/ The petitioners were critical to the perpetration of this fraud on the shareholders of the IOS funds. 32/ As discussed above, Lipper Corp. was formed for the purpose of serving as IOS's representative in the American securities markets and was the conduit through which $1.4 million of commissions were funnelled to IPC.

Similar, although perhaps less flagrant, participation by a broker-dealer in an investment adviser's scheme to obtain for itself a portion of a mutual fund's commission also resulted in sanctions for aiding and abetting violations of the antifraud rules in Provident Management Corporation, 44 SEC 442 (1970). There the investment adviser required those brokers to whom it directed fund portfolio

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31/ Doc. 358, R. 3853, A. 433, quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6 (1934). See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 196 (1963).

32/ Rule 10b-5, 17 CFR 240.10b-5, which the Commission found petitioners to have violated, prohibits, among other things, employment of "any device, scheme, or artifice to defraud" and participation in "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

business to return a portion of the commissions to the adviser. 33/ Such brokers "knowingly aided . . . an affiliate of Fund, in instituting the mechanism whereby the . . . respondents were enriching themselves by improperly utilizing the brokerage generating capacity of the Fund assets." 44 SEC at 448.

Lipper and Cowett presumably recognized that meaningful disclosure to the directors and shareholders of the IOS-affiliated funds would not be possible, since the kickbacks were clearly detrimental to the funds, and the interests of IOS, IPC, and Lipper Corp. were contrary to those to whom disclosure was owed. Accordingly, incomplete and misleading information was given to the fund boards. 34/ For example, at one of the FOF directors' meetings, Conwill, whose firm was acting as counsel to FOF, had served as counsel for IOS, and who was himself Lipper's counsel, advised the Board that there existed no legal way that FOF could obtain any benefit from the commissions being paid to Lipper Corp. (Doc. 1, R. 684, 1021-22, 1066-71, 1074; A. 256-57, 301-06, 309). Conwill and Cowett failed to advise the board that substantial monetary benefits could have been obtained through reduced

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33 The Commission said that it was unnecessary to demonstrate that this practice resulted in any added expense to the fund. "[O]nce the reciprocal arrangements were made, it was improper for [an affiliate of the adviser] to keep for itself rather then confer on Fund the benefits attributable to Fund's assets." 44 SEC at 447.

34/ Rule 10b-5(b), *supra*, prohibits the making of "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading."

The Commission found that there was no effective disclosure of the IOS/Lipper scheme to the boards of the foreign funds. The only specific disclosure of any of the boards was that made by Mr.

(footnote continued)

commissions on a bona fide reduced agency rate, or through a reduction in the advisory fees (Doc. 1, R. 1021-22, 1066-75; A. 256-57, 301-10).

Moreover, the mutual funds' shareholders were not told that IPC was furnishing no services in return for the monies being diverted through Lipper Corp., that Mr. Lipper's profits -- of which the funds' assets were the source -- were "exorbitant," or that these arrangements had been made at the expense of alternatives available by which the funds' shareholders could have benefited instead (Doc. 1, R. 592-95, 608-10, 649-52, 968-69, 1076-88; A. 90-93, 106-08, 130-33, 311-23). Indeed, the shareholders were not told anything at all concerning the fact that IOS, through this scheme, was recapturing for IPC substantial portions of the brokerage commissions being paid by the funds on over-the-counter portfolio transactions.

Likewise, Lipper and Lipper Corp., in order to ensure the success of IOS's breach of its fiduciary duty, disregarded their own obligations to their customers, the IOS funds. As executing agent for the over-the-counter portfolio transactions of FOF, FOF Prop., IIT, and Regent, peti-

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34/ (footnote continued)

Conwill to FOF's board of which he was a member. Cf., Schoenbaum v. Firstbrook, 405 F. 2d 200, 211-12, reversed in part on other grounds en banc, 405 F. 2d 215 (C.A. 2, 1968), certiorari denied, sub nom., Manley v. Schoenbaum, 395 U.S. 906 (1969):

> "In general, if the corporation's agents have not been deceived, neither has the corporation. However, as in other situations governed by agency principles, knowledge of the corporation's officers and agents is not imputed to it when there is a conflict between the interest of the officers and agents and the interests of the corporate principal. [Citations omitted.] Therefore, a corporation may be defrauded in a stock transaction even when all of its directors know all of the material facts, if the conflict between the interests of one or more of the directors and the interests of the corporation prevents effective transmission of material information to the corporation, in violation of Rule 10b-5(2)."

Cf. Pappas v. Moss, 393 F. 2d 865, 868-69 (C.A. 3, 1968).

tioners owed a duty to the funds to deal fairly with them and to obtain the best price and execution. 35/ Petitioners, however, chose to enmesh themselves in an arrangement with IOS which required charging the funds an unnecessarily high rate of commission. As a result, the funds, in effect, paid $1.4 million to IPC which performed no service in return for the monies received (Doc. 1, R. 592-95, 968-69, 1077-88; A. 90-93, 312-23). 36/ Since the commission rate was negotiable, 37/ the funds were obviously not receiving the best price and execution.

In Delaware Management Company, Inc., 43 SEC 392 (1967), the Commission, in accepting offers of settlement, examined the obligation of a broker-dealer executing over-the-counter portfolio transactions for a mutual fund to refrain from causing the fund to incur unnecessary expense. In that case, the investment adviser, in order to encourage the sale of fund shares and thereby increase its own underwriting concessions, caused its funds to execute their portfolio transactions through a particular broker-dealer which also sold the funds' shares. The interpositioning of that broker between the funds

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35/ See Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 596-97 (C.A. 2, 1969); Hughes v. Securities and Exchange Commission, 174 F. 2d 969, 976-77 (C.A.D.C., 1949); Charles Hughes & Co. v. Securities and Exchange Commission, 139 F. 2d 434, 436-37 (C.A. 2, 1943), certiorari denied, 321 U.S. 786 (1944).

36/ The Commission stated, in its decision, that if the IOS respondents "had the capacity to cause any part of the commissions to leave the hands of the executing broker, they were bound to use that part to buy research and related services of value to FOA's shareholders." To the extent that IOS chose to have Lipper Corp. give-up a portion of its commissions, they should have gone to benefit the fund's shareholders in some manner, not simply to benefit IOS (Doc. 358, R. 3864-65, A. 445-46).

37/ Doc. 358, R. 3858, A. 437. See pp. 35-37 infra.

and the market makers from which a more favorable price could have been obtained constituted violations of the antifraud provisions of the securities laws by both the investment adviser and the interposed broker-dealer:

> "It is clear that the officers of the Funds had a fiduciary responsibility to the Funds and their shareholders to seek the most favorable execution of portfolio transactions. In handling the Funds' portfolio transactions those officers . . . disregarded that responsibility by engaging in the practice of interposing [one of the respondents] between the Funds and the best market. . . . We find that the course of conduct engaged in here . . . constituted a fraud upon the Funds and their shareholders." 43 SEC at 395-96. 38/

38/ See Sinclair v. Securities and Exchange Commission, 444 F. 2d 399, 400-01 (C.A. 2, 1971).

See also Consumer-Investor Planning Corporation, supra. There the investment adviser to a fund caused portfolio transactions to be directed only to those brokers who would, in return, agree to pay a portion of the commissions earned to the adviser. The Commission observed:

> "It is clear that [respondents] . . . sought out, and placed the purchase and sale of the Fund's portfolio securities with those brokers who would pay over to them the largest extractable portions of the brokerage commissions thus generated and the most substantial other benefits. The payments and benefits received by them did not represent compensation for any services rendered to or benefits conferred upon the Fund, but rather constituted a form of personal enrichment derived from the Fund's portfolio transactions. By such blatant trafficking of the Fund's business, respondents simply used their fiduciary positions in relation to the Fund to cause monetary and other benefits to inure to themselves without regard to what was best for the Fund." 43 SEC at 1100-01.

II. GIVE-UP PRACTICES ON THE EXCHANGE ARE IRRELEVANT TO THIS CASE; THEY WERE NOT PERMITTED IN THE OVER-THE-COUNTER MARKET

Petitioners cannot and do not contest the unsavory conduct of IOS; nor do they dispute that they materially facilitated and participated in IOS's conduct. That conduct redounded to the detriment of shareholders in IOS-affiliated funds, and that is the gravamen, as discussed above, of the Commission's determination that Lipper and Lipper Corp. were and are no longer suited to practice as a broker or dealer in securities.

Rather than meeting this contention head on, the petitioners seek to engage this Court in an irrelevant excursion into the give-up practices that prevailed on national securities exchanges up until 1968, when those practices were outlawed. Similarly, quoting from isolated portions of this Commission's amicus curiae brief in Tannenbaum v. Zeller, No. 75-7503, pending sub judice before this Court, petitioners seek to inject wholly irrelevant, post hoc rationalizations for their knowing, willful and deliberate participation in, and facilitation of, IOS's nefarious conduct.

A. While the Structure Of The Exchange Permitted Give-Ups To Develop, Congress Never Intended To Tolerate That Practice In The Over-The-Counter Market

As this Court is aware,[39/] stock exchanges, from their inception in 1790, maintained a system of fixed commission rates their members were

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39/ Gordon v. New York Stock Exchange, Inc., 498 F. 2d 1303 (C.A. 2, 1974), aff'd, 422 U.S. 659 (1975).

required to charge the investing public and limited the number of persons who could become members. As the Supreme Court noted just last term, 40/ these practices were acquiesced in, but not encouraged by, the Congress when it passed the Securities Exchange Act in 1934. 41/ Instead, the Commission was expected to monitor fixed rates and their affect on the structure, fairness and honesty of the markets. 42/ In the 1960's, the maintenance of fixed commission rates, coupled with limited membership in, and access to, the exchanges, gave rise to the practice of give-ups, a practice itself engendered by the increased institutionalization of the marketplace during that period. 43/ Because institutional investors, such as mutual funds, purchased and sold large quantities of securities, brokers could effect transactions on behalf of those institutions at greatly reduced costs, directly attributable to economies of scale.

40/ Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 664-67 (1975).

41/ See, *e.g.*, former Section 3(a)(3) of the Securities Exchange Act which, prior to the enactment of the Securities Act Amendments of 1975, *supra*, defined an exchange "member" as a person entitled to make use of exchange facilities without payment of the usual commission or fee.

42/ See former Section 19(b)(9) of the Securities Exchange Act which, prior to the enactment of the Securities Acts Amendments of 1975, *supra*, authorized the Commission to alter exchange rules pertaining to fixed rates of commission.

43/ See generally Securities Exchange Act Release No. 9950 (Jan. 17, 1973).

Yet, the Constitution and rules of the New York Stock Exchange during that period required that brokers continue to charge fixed rates. And institutions could not obtain exchange membership in most cases. This practice was justified, in part, because it was thought that membership on the exchanges would dissipate if there were no incentive to members to retain their expensive seats on the exchange. 44/ That incentive was thought to be provided by the fixed rate structure, which gave members the advantage of paying less than the fixed commission charges members were otherwise required to charge nonmembers and the investing public.

When institutions, with their increased bargaining power, became aware of the tremendous economies their larger transactions generated, they insisted that brokers reduce their commission charges. Because that was prohibited under the exchanges' rules, give-ups became the order of the day. But, the Commission eventually put a halt to those practices when, after careful study and lengthy hearings, 45/ it became apparent that the major justification posited for such practices -- the structure and viability of the exchanges -- was not valid. Ultimately, of course, not only were give-ups abolished 46/ and volume discounts instituted,

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44/ See *id.* at 167-68.

45/ See *id.* at 10-36.

46/ See n. 53 *infra*.

but fixed rates were completely eliminated, 47/ and Congress recently reaffirmed that Commission decision by statutory amendment to the Securities Exchange Act. 48/

The over-the-counter markets, however, were and are entirely different. Membership -- in the sense described above for the exchanges -- was simply not a relevant concept; any one could participate in the over-the-counter markets. And, there was not a history, two centuries long, of fixed rate practices in the over-the-counter markets as existed for exchanges. Indeed, when Congress adopted the Maloney Act of 1938, 49/ to extend broad Commission regulation to the over-the-counter markets, it expressly prohibited the NASD -- the self-regulatory agency performing the same initial oversight function of the over-the-counter markets that the exchanges perform for the exchange markets -- from fixing rates in any way, shape or form, 50/ with the sole exception of its edict that the NASD should insure that practices such as gouging and excessive profiteering in the form of mark-ups should not take place. 51/

47/ Securities Exchange Act Release No. 11203 (Jan. 23, 1975).

48/ See Section 6(e), 15 U.S.C. 78(f)(e), added by the Securities Acts Amendments of 1975, supra.

49/ 52 Stat. 1070.

50/ This prohibition is presently codified in Section 15A(b)(6) of the Securities Exchange Act, 15 U.S.C. 78o-3(b)(6).

51/ 52 Stat. 1071 enacting former Section 15A(b)(7) of the Securities Exchange Act.

Incredibly, petitioners seek to obscure the important differences between these two diverse markets in an attempt to suggest that the bare tolerance exhibited for a short time for give-ups in the exchange markets, where structural ramifications were rampant, should also apply to the over-the-counter markets, markets which Congress painstakingly insured would not be subject to precisely the kind of conduct which Lipper and Lipper Corp. encouraged, facilitated, and brought to fruition.

The fact of the matter, as the record in this proceeding demonstrates, and as petitioners and their counsel well knew, is that give-ups were neither required nor tolerated in the over-the-counter markets.

B. No Fixed Minimum Rate Of Commission Existed In The Over-The-Counter Market

The analysis in petitioners' brief proceeds from the erroneous assumption that fixed commission rates existed *de facto* in the over-the-counter market. Thus, they argue, commission sharing in that market was comparable to give-ups on Exchange business. The evidence established that the Exchange had no power to set its members' over-the-counter charges, and it did not purport to do so. Neither Exchange requirements nor member practice precluded a reduction of commissions on off-board transactions. Robert Bishop, vice-president in charge of the Exchange's Department of Member Firms, testified that minimum commissions applied to Exchange trades only and not to over-the-counter transactions. He further stated that the Exchange claimed no authority to establish rates

over-the-counter business. Bishop's testimony on this point was clear:

> "Q. Now, let me give you a hypothetical. If a Member Firm were executing listed business on the New York Stock Exchange for an institutional client, would the New York Stock Exchange require that said member charge a minimum stock exchange commission on over-the-counter transaction executed for the institutional client?
>
> A. No, we would not require that, but we would certainly expect the member firm to demonstrate to us, if they did it at less than the usual commission, to demonstrate that they were not doing it below cost. In other words, that they weren't engaging in indirect rebating." (Doc. 1, R. 1090; A. 325; see also Doc. 1, R. 1088-89, 1098-99, A. 323-24, 333-34). 52/

The record also established that, had petitioners wished to do so, they could have satisfied the Exchange that they were covering their costs at a rate of commission on over-the-counter business for IOS funds considerably below the Exchange minimum. The clearest evidence of this fact is that, from its inception in 1967, Lipper Corp. surrendered to IOS 50 percent of its charges for the over-the-counter business of IOS's funds. Lipper, who, pursuant to his and Cowett's plans, had left his previous employment and established Lipper Corp., would hardly have agreed to such payments had it meant that Lipper Corp. would be unable to cover the costs of its IOS business. In fact, as we have already pointed out, Lipper Corp. was such a profitable venture as a result of the IOS-generated business that Mr. Lipper expressed to Mr. Cowett that the profits he was making were "exorbitant" (Doc. 1, R. 637, 869-73, 904-05, A. 118,182-186, 209-10).

52/ For this reason, there was no inconsistency, as petitioners argue (Pet. Br. 17), between the Commission's statement that the Exchange lacked authority over commissions charged in the over-the-counter market and Mr. Bishop's testimony that the Exchange would not tolerate utilization of below cost, over-the-counter rates as a means to evade the Exchange's anti-rebate rules.

Petitioners' treatment of customers other than IOS's funds and their practices following the abolition of give-ups on Exchange transactions belie their purported respect for the sanctity of the minimum rate schedule. Early in 1968, petitioners, without consulting the Exchange, ceased charging any commission at all for executing, as an agent, over-the-counter transactions for registered investment companies (Doc. 1, R. 882; A. 189). This total waiver of charges was not, however, extended to IOS's affiliated funds which continued to be charged the Exchange minimum rate (Doc. 1, R. 891-92; A. 198-99). In early 1969, Lipper Corp. began to charge all of its clients, including IOS's funds, six cents per share (Doc. 1, R. 557, 891-92; A. 198-99). This occurred several weeks following action by the Exchange prohibiting its members from paying give-ups; accordingly, the rationale for charging the IOS funds a rate of commission exceeding Lipper Corp.'s cost no longer existed (Doc. 1, R. 1028-34; A. 263-69). The Exchange required Lipper Corp. to demonstrate that the six cents charge, which was far below Exchange rates, covered Lipper Corp.'s costs. Lipper Corp. thereupon "submitted many studies" to the Exchange to this effect (Doc. 1, R. 1033; A. 268). These facts demonstrate, as the administrative law judge found, that "the failure to afford the IOS funds a reduction in commissions must be attributed to respondent's desire to accommodate Cowett in his objectives and not to any proscription to be found in the NYSE rules" (Doc. 286, R. 3069; A. 414).

C. Over-The-Counter Give-Ups Were Essentially Fraudulent

In order to promote the IOS/Lipper scheme, petitioners imported the give-up practice from the environment of Exchange transactions in

which its rationale, fixed commissions, existed to the over-the-counter market where it served no legitimate purpose. 53/ There was no necessity in the over-the-counter market for an executing broker to devise ways in which to surrender a part of his commission to attract customers while, at the same time, avoiding a rebate. The broker could simply negotiate a lower charge with the customer in the first place. 54/

53/ On the Exchange, where a minimum commission was mandatory, the broker executing large transactions for institutional customers might frequently find himself compelled to charge a commission which substantially exceeded its costs. Pressure, therefore, developed to devise ways in which the broker could surrender part of this commission at the customers' direction but without violating the Exchange's rules prohibiting rebates and requiring adherence to the established rate schedule. Give-ups were one result of this pressure. Whether give-ups were good or bad, the significant point in the context of this litigation is that such payments were a consequence of the fixed rates of commission which applied only to Exchange transactions. Petitioners, however, were not charged with giving up Exchange commissions but, rather with sharing over-the-counter commissions. In that market, such payments served no legitimate purpose.

The Exchange prohibited give-ups effective December 5, 1968. Beginning in 1968, the fixed commission-rate system was gradually changed by the introduction, first, of volume discount, and later, in successive stages, of negotiated rates for transactions exceeding certain sizes. Finally, in 1975, the Commission, by adoption of Securities Exchange Act Rule 19b-3, 17 CFR 240.19b-3, abolished fixed commissions entirely.

54/ As we have already argued, Lipper Corp. in executing as agent the over-the-counter portfolio transactions for the IOS funds had a fiduciary duty to the funds to deal with them fairly and to obtain the best price and execution. If petitioners sincerely believed that the rules of the New York Stock Exchange required them to employ the minimum rate schedule to over-the-counter business, their own fiduciary obligations to their customers, the IOS funds, seemingly would have required that petitioners advise the funds to direct their over-the-counter business to a non-Exchange

(footnote continued)

The inherently fraudulent nature of over-the-counter "give-ups" was well-recognized even prior to the formation of the IOS/Lipper scheme. 55/ In 1966, the Commission's Public Policy Report stated:

> "A directed give-up of a portion of the commission charged for handling a transaction for a fund in the over-the-counter market would be a patent waste of investment company assets. Since the over-the-counter market in both listed and unlisted securities is a negotiated market, which is not governed by fixed prices or minimum commission rate schedules, any willingness of the executing broker or dealer to allow his customer to direct a give-up of a portion of his commission or mark-up to dealers in fund shares in and of itself shows that a lower price or commission could have been negotiated." H.R. Rep. No. 2337 at 178. (emphasis added)

and

> "In the over-the-counter markets, where brokerage costs are subject to negotiation, give-ups of commissions to brokers who perform no necessary function in connection

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54/ (footnote continued)

member which would not have been bound, even under petitioners' theory, by the Exchange's commission schedule and, thus, could have effected more economical execution. Petitioners, however, did not do so because the success of the IOS/Lipper scheme depended on the generation of excess cash from substantial commission charges against the funds.

55/ Petitioners do not point to any authoritative expression to the contrary, and concede (Pet. Br. 19) that the "best evidence of the attitutde of the NYSE" towards over-the-counter give-ups which they have located is an informal communication from the president of the Exchange to its members which discusses give-ups. One paragraph of that report, quoted in petitioners' brief at page 20, refers to over-the-counter give-ups as a practice which "has arisen" and in which "some member firms" participate. Nothing in this document suggests that the Exchange, in this passing reference, meant to advise members that over-the-counter give-ups were permissible (Doc. 194, R. 2451; A. 388).

> with a transaction have long been recognized as improper and illegal. Give-up practices have been tolerated in the exchange markets only because brokerage costs are fixed by the exchange minimum commission rate schedules." 56/ Id. at 185.

On July 18, 1968, the Director of the Commission's Division of Trading and Markets sent a letter to the presidents of all stock exchanges and of the NASD dealing with the subject of give-ups and other reciprocal practices. Director (now Commissioner) Pollack stated therein that "'give-ups' in the over-the-counter market have long been recognized to be improper and illegal." 57/ This letter was published in both the Congressional Record 58/ and the Federal Securities Law Reporter. 59/ See also 5 L. Loss, Securities Regulation 3174 (1969):

> "'give-ups' in the over-the-counter market have long been recognized to be illegal; for, in the absence of any fixed commission, the broker-dealer's commission (or spread in the case of a principal transaction) would be presumptively loaded (in law if not in fact) by the amount of the 'give-up,' in fraud of the fund whose management placed the over-the-counter order." 60/

56/ Accord Report of Special Study of Securities Markets, supra, pt. 4 at 226-35 (1963).

57/ Doc. 145, R. 2[illegible]. 379.

58/ 112 Cong. Rec. [illegible],856-58 (1966).

59/ CCH Fed. Sec. L. Rep. ¶77,360 at 82,664-666 (1966).

60/ Accord R. Driscoll, Procedures of Affiliated Funds and American Business Shares in Buying and Selling Portfolio Securities 14 (1965):

> "In an over-the-counter transaction, those who perform no service should not participate in commissions or profits and there should be no give-up arrangements with them. Obviously, if a negotiated commission or price allows for a give-up of a portion of the commission or profit, a better execution for the investment company could have been negotiated if no give-up had been involved."

The facts of this case illustrate the reasons why Professor Loss characterized over-the-counter give-ups as presumptively fraudulent. The unnecessarily high commissions which Lipper Corp. charged the IOS funds served to generate a pool of cash which IOS and Lipper utilized to further their own objectives. The funds' shareholders derived no benefit from these assets. The existence of this pool of shareholder funds did, however, permit petitioners to aid IOS in defrauding the funds under the guise of emulating Exchange commission-sharing practices.

Finally, it bears little emphasis, in our view, to note that petitioners' attempts to cull from the Commission's _amicus curiae_ brief in _Tannenbaum_, _supra_, bits and scraps that might lend some credence to their improbable arguments are without merit.

In _Tannenbaum_, a private action for damages as opposed to this remedial action by the Commission seeking to determine the fitness and character of the petitioners to handle other people's investments, this Court is faced with a decision by the independent directors of a mutual fund to use excess commissions, generated from exchange transactions (_not_ over-the-counter transactions), to purchase services that arguably benefitted both the fund's adviser and the fund's shareholders. 61/

61/ Petitioners characterize (Pet. Br. 32) as "very naive" what they perceive to be the "apparent economic thesis of the SEC" in its position in the _Tannenbaum_ brief. This thesis is said to be that a mutual fund

> "adviser may derive the economic benefit of a higher advisory fee (sales fees, custodial fees, directable commission business, float income) from increased mutual fund sales and the economic benefit of subsidized investment research. Why is cash in the hand an unlawful economic benefit as a truly different form of incremental income from that which may be of equal economic value to the advisor?" (_Id._)

(footnote continued)

Thus, the directors chose not to recapture the excess portion of Exchange fixed commissions paid, but rather, used those funds to reward brokers who provided research services to the advisers and brokers who sold the fund's shares. In contrast, in this case, Lipper Corp. funnelled give-ups to IPC in response to IOS's command, and in return for absolutely no services or benefits of any kind. Those give-ups were intended to, and in fact did, benefit only Lipper Corp., IOS and IPC. By no stretch of the imagination could it be argued here that those payments were intended to benefit the IOS-affiliated fund shareholders.

61/ (footnote continued)

The short answer is, as we have stated in the text above, that the question is asked from the viewpoint of the benefit to the adviser (a viewpoint pervading the petitioners' brief) whereas the Commission's analysis in Tannenbaum proceeds from the viewpoint of the benefit to the fund's shareholders.

The further answer to petitioners' question, why "cash in the hand" of the adviser is not really the same as other economic benefits, is that cash in the hand of the adviser cannot possibly benefit the funds' shareholders, only the adviser. We said as much in our Tannenbaum brief (p. 36, n. 46, attached to petitioners' brief):

> ". . . if the directors in this case, instead of deciding to use the excess brokerage commissions to pay for sales and research services, had directed the excess to be paid to the adviser's broker affiliate, there would have been no discretion to permit the adviser to retain the benefits. Fiduciary principles would have required that the excess commissions be returned to the Fund."

III. NEITHER PETITIONERS' ALLEGED RELIANCE ON THE ADVICE OF COUNSEL, WHO WAS NOT DISINTERESTD, NOR THE POSSIBILITY THAT OTHER BROKER-DEALERS MAY HAVE ENGAGED IN MISCONDUCT SIMILAR TO PETITIONERS, INSULATED PETITIONERS FROM COMMISSION ADMINISTRATIVE ACTION; NOR CAN IT BE SAID THAT PETITIONERS ACTED IN GOOD FAITH 62/

A. Purported Reliance on Advice of Counsel

Even to a layman, much less to a sophisticated securities professional like Lipper, the type of flagrant misconduct in which petitioners engaged could hardly have seemed proper. Lipper, who

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62/ In connection with their protestations of good faith, petitioners also argue (Pet. Br. 40-42) that the Commission should have applied the law of New York (which they characterize as "the forum state") respecting the burden of proof. Petitioners contend that, under New York law, there is a "presumption of innocence" in common law actions for fraud, and that the evidence in this proceeding failed to rebut that presumption. In support of this theory, petitioners cite numerous opinions of the New York state courts in private actions for fraud. None of these cases involve the federal securities laws; indeed, the majority were decided many years before the enactment of those laws.

The argument that state law standards govern Commission administrative proceedings was rejected as far back as 1949:

> "Reduced to its essence, petitioner's argument in this court with all its many facets amounts to no more than a claim that common law fraud has not been proven and that the registration cannot be revoked without such proof. We must reject such a claim. To accept it would be to adopt the fallacious theory that Congress enacted existing securities legislation for the protection of the broker-dealer rather than for the protection of the public." Norris & Hirshberg v. Securities and Exchange Commission, 177 F. 2d 228, 233 (C.A.D.C., 1949).

See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 196; Hughes v. Securities and Exchange Commission, supra, 174 F. 2d at 975. See also Subin v. Goldsmith, 224 F.2d 753, 766 (C.A. 2, 1955) (Frank, J., dissenting); Grad v. Memorex Corp., 61 F.R.D. 88, 89 (N.D. Cal., 1973).

(footnote continued)

personally authorized the kickback checks (Doc. 1, R. 862-63, A. 175-176), knew that the over $1.4 million which he had charged the IOS mutual funds was being funnelled to IOS's subsidiary, IPC. It could hardly have been unclear to him that these payments were not designed to benefit the fund's shareholders. The situation is unlike one in which the question is the applicability of a statutory exemption [63/] or interpretation of the intricacies of a "regulatory scheme . . . [which was] far from a model of clarity." [64/]

62/ (footnote continued)

Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis., 1962), aff'd, 319 F.2d 634 (C.A. 7, 1963), on which petitioners rely, (Pet. Br. 40) does not support their position and is, in fact contrary. The court there held that Rule 10b-5 was more sweeping than common law fraud. "Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so." 208 F. Supp. at 823, quoting Ellis v. Carter, 291 F.2d 270, 274, (C.A. 9, 1961). The court also cited Norris & Hirschberg, supra, with approval.

63/ Cf. Securities and Exchange Commission v. Harwyn Industries Corp., 326 F. Supp. 943 (S.D.N.Y., 1971) (reliance on advice that an unusual spin-off transaction was exempt from registration); but see Securities and Exchange Commission v. M. A. Lunday Associates, 362 F. Supp. 226, 233 (D.R.I., 1973) (court noting that defendants failed to seek advice from the Commission).

64/ United States v. Crosby, 294 F.2d 928, 943 (C.A. 2, 1961), certiorari denied sub nom. Mittelman v. United States, 368 U.S. 984 (1962). Cf., Securities and Exchange Commission v. Talley Industries, Inc., 399 F. 2d 396 (C.A. 2), certiorari denied sub nom. General Time Corp. v. Securities and Exchange Commission, 393 U.S. 1015 (1969), where this Court found a violation of Section 17(d) of the Investment Company Act, 15 U.S.C. 80a-17(d), notwithstanding that "[n]o decided case had ever applied §17(d) to a situation like that here, and conscientious counsel could well have believed the reservations Chestnutt stated were sufficient to make it inapplicable." Id. at 406.

Whatever weight good faith reliance on advice of counsel may generally carry as a factor in the Commission's determination of the appropriate sanction in administrative proceedings, it merited precious little consideration in this case. First, the attorney on whom Lipper chose to rely, Alan Conwill, was not disinterested; he was an FOF director and also counsel for IOS (Doc. 1, R. 939, A. 215) - - the entity which stood to profit from the conduct in question. In Fogel v. Chestnutt, supra, CCH Fed. Sec. L. Rep. ¶95,393, at p. 98,996, this Court pointed out:

> "It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors."

It is clear that one may not avoid liability under the federal securities laws simply by relying on the advice of his counsel. Such reliance is only one factor to be considered, and its significance in a particular case depends upon the circumstances. See, e.g., Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F. 2d 1082 (C.A. 2, 1972); United States v. Schaefer, 299 F. 2d 625, 630-31 (C.A. 7), certiorari denied, 370 U.S. 917 (1962); Linden v. United States, 254 F. 2d 560, 568 (C.A. 4, 1958).

And, under the circumstances here, relying on Conwill's advice was a highly risky gamble. For his advice was not that the IOS/Lipper scheme was lawful. To the contrary, Conwill informed Lipper that the

Commission regarded give-ups on over-the-counter transactions as illegal,[65/] but that he, Mr. Conwill, personally believed that the Commission's staff was "wrong, as a matter of law." (Doc. 1, R 1053, A. 288).[66/] Despite the manifest risk of acting on the basis of an opinion qualified in that manner, Lipper elected to proceed. Lipper never consulted other counsel, nor did he contact the Commission. In its opinion, the Commission aptly noted that

> "[Petitioners] relied upon counsel's conclusion that they had discovered a loophole in the law of fiduciary responsibility . . . . [T]hey can hardly claim that they could not reasonably foresee that the loophole which they perceived might prove to be illusory." (Doc. 358, R. 3859, A. 439).

In a similar context, such unquestioning reliance on the advice of counsel that recapture of commissions for the benefit of investment company shareholders was illegal has been found unwarranted, particularly

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65/ In United States v. Crosby, supra, 294 F. 2d at 942, on which petitioners rely (Pet. Br. 23-24), this Court concluded that the legal opinions on which defendants therein has relied were not "so patently erroneous as to permit the jury to speculate on the good faith of the defendants." Conwill's advice, in contrast, carried its own indiciation of questionability--he himself admitted that his views were in opposition to those of the Commission's staff.

66/ Conwill's disregard for the views of the agency which regulated his client's business continued through the time of the hearing in this proceeding:

"Q. Did you make any inquiry of the SEC of the -- whether or not there was a minimum rate?

A. No sir.

(footnote continued)

after the release of the Public Policy Report in 1966.[67/] In Papilsky v. Berndt, CCH Fed. Sec. L. Rep. ¶95,627 (S.D.N.Y., June 24, 1976), the court observed that "defendants were excessively willing, approaching eagerness, to dismiss without inquiry or full disclosure, the statements of the SEC . . . and to rely blandly on advice of illegality. Cf. Matter of Arthur Lipper Corp." ¶95,627 at 90,133. Similarly, in Moses v. Burgin, 445 F.2d 369 (C.A. 1), certiorari denied, 404 U.S. 994 (1971), the First Circuit, referring to the same Commission statement involved in this case. stated, "Any contention that the Commission's views were off-hand or so inconsequential that . . . defendants were entitled to keep their own counsel . . . is, to put it bluntly, little short of extraordinary." 445 F.2d at 384.

66/ (footnote continued)

> Q. Why not?
>
> A. My grin is not intended to be in any respect disrespectful, Mr. Examiner.
> Having been on the staff of the SEC, Mr. LaPrade, I know what the answer of almost any staff member of the Commission would be . . . ." (Doc. 1, R 1053, A. 288).

67/ In Moses v. Burgin, supra, 445 F.2d at 383-84, the First Circuit treated the Public Policy Report, supra, as putting defendants "on full notice that the possibility of recapture was a substantial issue."

B. Petitioners Did Not Act In Good Faith

As we have just seen, petitioners' conduct was intentional and knowing, and their claim of reliance on counsel cannot be credited. With respect to their contentions that they believed the Exchange's minimum commission and anti-rebate rules required them to kickback to IPC, petitioners made no effort to ascertain from officials of the Exchange whether they were in fact required to charge the minimum NYSE commission on over-the-counter transactions (Doc. 1, R. 564-66, 671-78, 684-85, 948-52, 1007-08, 1042-46, 1086-87, A. 75-77, 224-28, 242-43, 277-81, 321-22). Moreover, although the petitioners claim to have been in fear of disciplinary action by the Exchange, they never have explained why that fear did not restrain them from giving up to IPC, which was not a member of the Exchange. The Exchange's anti-rebate policy prohibited the division of commissions (on Exchange transactions) with those who were not themselves members of the Exchange (Doc. 358, R. 3856, A. 436).

Thus, their repeated assertions (Pet. Br. 3, 15, 22-23, 25) of good faith are hollow. Because petitioners knew exactly what they were doing, neither the Supreme Court's recent decision in Ernst & Ernst v. Hochfelder, 96 Sup. Ct. 1375 (March 30, 1976), nor this Court's decision in Lanza v. Drexel & Co., 479 F. 2d 1277 (C.A. 2, 1973), upon which petitioners seek to rely (Pet. Br. 22, 23, 25, 37, 40), have any bearing on this case. In each of these decisions, the defendant was sought to be held liable for money damages in private civil actions for his very lack of knowledge. Just last month, this Court underlined that distinction in Herzfeld v.

Laventhol, Krekstein, Horwath & Horwath, CCH Fed. Sec. L. Rep. ¶95,660 (July 15, 1976). There this Court factually distinguished the conduct of the accountants in Hochfelder from the conduct of the accountants in Herzfeld. While the theory of liability in Hochfelder was premised on negligence because the accountants had not been aware of facts plaintiffs alleged they should have known, this Court noted that in Herzfeld the audit had been made with "admitted awareness of the facts" ¶95,660 at p. 90,254.

> "The accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their active participation in the preparation and issuance of false and materially misleading accounting reports on which Herzfeld relied to his damage."
> Id. 68/

Petitioners' reliance on Shemtob v. Shearson, Hammill & Co., 448 F. 2d 442 (C.A. 2, 1971) (Pet. Br. 25), as evidencing a requirement that a showing of some form of scienter is required in order to sustain a violation of Section 10(b) and Rule 10b-5, is similarly misplaced -- not only because petitioners' conduct here was intentional and knowing, but also because

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68/ This distinction between knowing action and negligence also was drawn by the Court of Appeals for the Ninth Circuit in an order entered last month denying rehearing in United States v. Charnay, No. 75-1222 (C.A. 9, July 8, 1976). There, in a case which sustained a criminal indictment for violations of Section 10(b) and Rule 10b-5, the court of appeals held consistent with Hochfelder its ruling that it was necessary for the prosecution to show only an intentional act with "a realization on the defendant's part that he was doing a wrongful act." Slip op. at 3. Similarly, the court observed that one of the panel judges in his concurring opinion had noted that "the intent necessary . . . is merely that of intending to do the acts prohibited, rather than intent to violate the statute." Id.

Accord Bailey v. Meister Brau, Inc., CCH Fed. Sec. L. Rep. ¶95,543 at p. 99,735 & n.14 (C.A. 7, May 6, 1976).

scienter is not required to be shown in an enforcement proceeding by this Commission. 69/ This Court has repeatedly held that a showing of negligence is sufficient for the Commission to obtain injunctive relief, while private plaintiffs are required to prove the defendants' conduct was more culpable than merely negligent in order to recover money damages. See Securities and Exchange Commission v. Management Dynamics, Inc., 515 F. 2d 801 (C.A. 2, 1975); Securities and Exchange Commission v. Spectrum, Ltd., 489 F. 2d 535, 541 (C.A. 2, 1973); Lanza v. Drexel & Co., 479 F. 2d 1277, 1304 (C.A. 2, 1973); Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F. 2d at 1096 n. 15; and Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833, 854-55 (C.A. 2, 1968), certiorari denied, 294 U.S. 976 (1969). 70/ This distinction in the level of culpability between private

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69/ The Hochfelder decision does not evade the distinction between Commision enforcement proceedings and private actions for damages. In Hochfelder, the court noted, "Since this case concerns an action for damages we also need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5." 96 Sup. Ct. at 1381, n. 12.

In addition, the Court in Hochfelder did not address "the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5," although it recognized that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." Id. "Recklessness" as a standard for the imposition of civil money damage liability under Rule 10b-5 would seem to comport with the standard for such liability set forth in the two cases cited by petitioners -- Lanza v. Drexel & Co., supra, 479 F. 2d at 1306, (willful or reckless disregard for the truth) and Shemtob v. Shearson, Hammill & Co., supra, 448 F. 2d at 445 ("scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud"). We submit that, a fortiori, a recklessness standard would support liability in a Commission enforcement proceeding, and, if petitioners here were not acting intentionally, that there can be little doubt that their conduct was reckless.

70/ In this respect, Lanza v. Drexel & Co., supra, on which petitioners rely, is unavailing.

actions for money damages and Commission injunctive proceedings is rooted in sound policy. Private actions, while they have a deterrent effect to an extent, seek to redress victims with money damages for past violations of the law. In its injunctive proceedings, on the other hand, the Commission seeks to protect investors and the public from future violations of the law, and a defendant's conduct in a particular case, however it may be labelled, may demonstrate that, unless enjoined, he poses a threat to investors. Similarly, Commission administrative proceedings, as here, are prospective in nature; they are remedial in the sense that they seek to protect the public from future harm from the violator. 71/ A determination that a person should not be permitted to remain in the securities business could well be legitimately predicated on conduct which was, in a particular case, less than intentional and knowing.

C. Purported Misconduct of Other Registrants

Even if other brokers may, in fact, have paid give-ups on over-the-counter business, it does not follow that such conduct was necessarily comparable to petitioners' from the standpoint of the Commission's regulatory responsibilities. Lipper Corp. was formed for the specific purpose of funnelling commissions paid by to IOS-affiliated funds back to IOS. Dealings with IOS accounted for the great majority of Lipper Corp.'s total business --

71/ Indeed, here the Commission, after finding willful violations by IPC, dismissed this proceeding against that company because its present owners were wholly unaffiliated with IOS, and a sanction against IPC could not "achieve any remedial purpose" (Doc. 358, R. 3859, A. 452).

indeed the very rationale for Lipper Corp.'s existence was to serve as IOS's contact with the United States markets. This situation is not comparable to that of pre-existing, established firms which may have also paid some give-ups to IPC. Such firms were not shown to have made these payments in accordance with a plan to aid an adviser in obtaining assets from its clients. For these reasons, the Commission was justified in determining to devote a portion of its limited enforcement resources to Lipper and Lipper Corp.

The Commission's ability to enforce the federal securities laws would be emasculated were it open to respondents in an administrative proceeding to defend thenselves by demonstrating that others were also guilty of misconduct but had gone unpunished. "Under no circumstances . . . can [respondent] claim the existence of a general reprehensible practice to insulate himself from the effects of conduct which he knew or should have known operated as a fraud." Lawrence R. Leeby, 13 SEC 499, 511 (1943).

Both the Supreme Court 72/ and this Court 73/ have held that a claim of selective prosecution requires a showing "not only that others

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72/ Oyler v. Boles, 368 U.S. 448, 456 (1962).

73/ United States v. Ortega-Alvarez, 506 F. 2d 455, 458 (C.A.2, 1974), certiorari denied, 95 Sup. Ct. 1559 (1975); United States v. Berrios, 501 F. 2d 1207, 1211 (C.A. 2, 1974).

Other courts have likewise rejected claims of selective enforcement based solely on the assertion that other violators have not been prosecuted. See, e.g., Sanders v. Waters, 199 F.2d 317, 318 (C.A. 10, 1952); certiorari denied, 342 U.S. 929 (1952); Saunders v. Lowry, 58 F. 2d 158, 159 (C.A. 5, 1932) ("It has never been held that one guilty of a crime cannot be punished merely because others equally guilty have not been prosecuted and convicted.")

similarly situated were not prosecuted but also that the decision to prosecute [defendant] was based on impermissible considerations such as race or religion." United States v. Ortega-Alvarez, 506 F. 2d 455, 458 (C.A. 2, 1974), certiorari denied, 95 Sup. Ct. 1559 (1975). No such showing was attempted in this case, nor would one have been possible. Petitoners' position is more akin that that rejected in United States v. Brookshire, 514 F. 2d 786 (C.A. 10, 1975), where the defendant contended that the United States had selected his case to establish the illegality of a banking practice previously regarded as "normal and customary." 74/ 514 F.2d at 788. The court found this allegation irrelevant:

> "Defendant's claim of denial of due process is frivolous. His basic complaint is that he has been wrongfully singled out to test government theories as to the scope of §656. The statute makes no invidious discrimination . . . [and] [s]elective enforcement is not in itself a federal constitutional violation." 514 F.2d 788-89.

74/ In light of the Commission decisions and public statements discussed at pp. 25-30 and 37-40, supra, this proceeding did not, in any event, involve novel or experimental legal theories. And, even if it had, this Court has sustained the power of the Commission to interpret broad antifraud rules decisionally. See Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F. 2d at 859-62; Charles Hughes & Co. v. Securities and Exchange Commission, supra, 139 F. 2d at 437-38. Cf. Securities and Exchange Commission v. Chenery Corporation, 332 U.S. 194, 203 (1947):

> "[T]he agency must retain power to deal with the problems on a case-by-case basis if the administrative process is to be effective . . . . [T]he choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency."

IV. PETITIONERS' JURISDICTIONAL AND PROCEDURAL OBJECTIONS HAVE NO MERIT

A. The Commission Has Jurisdiction to Proceed Against a Registered Broker-Dealer Who Serves as a Link in a Scheme to Defraud Involving Transactions in the United States Securities Markets

The IOS-affiliated funds and their shareholders (including 3,000 Americans) were defrauded through payments: (1) made in the United States; (2) from one registered American broker-dealer (Lipper Corp.) to another American registered broker-dealer (IPC); (3) in connection with the purchase of securities of American companies; and (4) in the American over-the-counter market. This Court has observed:

> "We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners. This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States. By the same token it is hard to believe Congress meant to prohibit the SEC from policing similar activities within this country. . . ." IIT v. Vencap, Ltd., 519 F. 2d 1001, 1017 (C.A. 2, 1975).

The federal courts have repeatedly held that the federal securities laws preclude the use of the United States as a haven for the operation of securities frauds aimed at citizens of other nations. 75/ Neither Vencap,

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75/ See, e.g., IIT v. Vencap, Ltd., 519 F. 2d 1001, 1017 (C.A. 2, 1975); Securities and Exchange Commission v. Capital Growth Co., 391 F. Supp. 593, 596-97 (S.D.N.Y., 1974); Securities and Exchange Commission v. Gulf Intercontinental Finance Corp., 223 F. Supp. 987, 994-96 (S.D. Fla., 1963).

And, the application of the federal securities laws to prevent an American broker-dealer from aiding in the manufacture of fraud for export does not depend on whether the law of the victim's domicile would also afford him protection. Section 17 of the Restatement (2d) of the Foreign Relations Law of the United States provides:

(footnote continued)

supra. nor its companion case, Bersch v. Drexel Firestone, Inc., 519 F. 2d 974 (C.A. 2), certiorari denied, 96 Sup. Ct. 453 (1975), 1975), suggest that the Commission is powerless to discipline broker-dealers who engage in fraudulent securities transactions within the borders of the United States unless Americans alone are injured by the fraud. At most, those cases indicate only that, where a transaction is predominantly foreign, it does not give rise to private liability under the federal securities laws unless the activities in the United States are more than "preparatory." Nothing in either case suggests that a registered broker-dealer is free to ignore the requirements of the Commission's antifraud rules when he deals, in the United States, with aliens. Nor does either case lend support to petitioners' proposition that, so long as the majority of the victims of a fraud are foreigners, the Commission "should not concern itself" (Pet. Br. 47). On the contrary, "subject matter jurisdiction attaches whenever there has been significant conduct with respect to the alleged violations within the United States." Travis v. Anthes Imperial Ltd., 473 F. 2d 515, 524 (C.A. 8, 1973).

Section 30(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78dd(b), which exempts "any person insofar as he transacts a business in securities without the jurisdiction of the United States" does not, as petitioners suggest (Pet. Br. 48), insulate them from Commission scrutiny of their involvement in the IOS/Lipper scheme. Even if Section 30(b) were read narrowly as limiting the Commission's jurisdiction to

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75/ (footnote continued)

"A state has jurisdiction to prescribe a rule of law

(a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory. . . ." (emphasis added)

the territorial boundaries, 76/ petitioners would fall within that jurisdiction because Lipper Corp. was registered with the Commission as a broker-dealer in securities and conducted its business in New York City. Petitioners assert that IOS's business was "without the jurisdiction of the U.S." Petitioners' violations, however, resulted from their dealings with IPC, which, like Lipper Corp., was a Commission registrant with its office in New York City. 77/ IOS controlled IPC and owned 80 percent of its stock (Doc. 365, R. 3910. 78/ Mr. Cowett, IOS's executive vice president,

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76/ It has, however, repeatedly been held that Section 30(b) does not impose such a limitation. See, e.g., Securities and Exchange Commission v. United Financial Group, Inc., 474 F. 2d 354, 357-60 (C.A. 9, 1973); Roth v. Fund of Funds, Ltd., 405 F. 2d 421, 422 (C.A. 2, 1968), certiorari denied, 394 U.S. 975 (1969); Schoenbaum v. Firstbrook, 405 F. 2d 200, 207-08 (C.A. 2, 1968), reversed in part en banc on other grounds, 405 F. 2d 215, certiorari denied sub nom., Manley v. Schoenbaum, 395 U.S. 906 (1969).

77/ In Roth v. Fund of Funds, Ltd., supra, 405 F. 2d at 422, this Court held that FOF, one of the funds defrauded by petitioners, was subject to Commission jurisdiction in connection with transactions on the American securities markets:

> "The Fund [FOF] contends that . . . as its offices are in Geneva, Switzerland, it transacts this business 'without the jurisdiction of the United States.' However, Section 30(b) is inapplicable because when the Fund bought and sold the securities in question on the New York Stock Exchange, utilizing New York City stock brokers to execute its orders to buy and sell, and made payument of the purchases through a New York bank, it was not transacting a 'business in securities without the jurisdiction of the United States.'"

78/ Section 15(b)(6) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b)(6) provides that the Commission may impose administrative sanctions against any person [IOS here] "associated with" a broker-dealer [IPC here] which has violated the Act or the Commissions' rules thereunder. Section 3(a)(18) defines "person associated with a broker-dealer" to include "any person directly or indirectly controlling . . . such broker or dealer." Prior to the Securities Acts Amendments of 1975, supra, Section 15(a)(6) was numbered Section 15(b)(7)).

devised the kickback scheme in which petitioners participated, and IOS derived the benefits from that plan through payments made to IPC.[79/]

Petitioners err in assuming (Pet. Br. 44-45) that, because only 3,000 American shareholders, representing 3 percent of FOF's shareholders, were shown to have been victimized by petitioners' conduct, the Commission should have ignored their activities. In Securities and Exchange Commission v. United Financial Group, Inc., 474 F. 2d 354 (C.A.9, 1973), defendants, several off-shore mutual funds and their holding company parent, likewise contended that they were without the jurisdiction of the federal securities laws because most or all of their sales had been made to foreigners. Finding only three Americans, holding approximately $10,000 worth of the defendant's shares, the court thus rejected "a mere tallying of domiciles of shareholders" as the proper jurisdictional test. 474 F. 2d at 356. Disregarding "relative number of American citizen shareholders vis-a-vis alien shareholders," the Court instead focused "upon appellants' activities within the United States and the impact of those activities upon American investors," 474 F. 2d at 356-57, and concluded that "the jurisdictional hook need not be large to fish

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79/ Petitioners also argue that the Commission lacked jurisdiction because "the shareholders [of the foreign funds] could only have been defrauded in connection with their purchases of shares of the foreign investment companies" (Pet. Br. 43), and it was not shown that the jurisdictional means were used in connection with such transactions. This assertion simply ignores the nature of the Commission's case. The manner in which petitioners defrauded the funds' shareholders was by charging the funds unnecessary and excessive commissions in connection with securities purchases in the United States and then funnelling a portion of those commissions to IPC.

for securities law violations."[80/] Even disregarding the nature of petitioners' conduct in the United States is disregarded, the effect their scheme on American investors was, in itself, sufficient to warrant the Commission's exercise of jurisdiction.

Finally, even if the Commission's administrative jurisdiction over one of its registrants were to be measured by the same tests as a private plaintiff's ability to utilize the federal courts, the facts in this case would support jurisdiction. In Vencap and Bersch, both of which also involved the IOS financial empire, this Court identified three possible bases for the assertion of federal subject matter jurisdiction in private damage actions: (1) "the United States . . . power to prescribe the conduct of its nationals everywhere in the world," [Vencap, supra, 519 F. 2d at 1016; see Bersch, supra, 519 F. 2d at 985]; (2) the occurrence of "activities [which] had a significant effect in the United States" [Vencap, supra, 519 F. 2d at 1016; see Bersch, supra, 519 F. 2d at 987-89]; or (3) the occurrence of "activity within the United States" [Vencap, supra, 519 F.2d at 1017; see Bersch, supra, 519 F. 2d at 985], but where the effect of such activity is to defraud

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80/ Concerning that holding, this Court has stated that:

> "[W]e doubt that the result in [United Financial Group] would have differed if the court had not been able to find that the issuer was an American corporation and that three American investors held $10,000 of its probably worthless stock. If there would be subject matter jurisdiction over a suit by the SEC to prevent concoction of securities fraud, in the United States, there would also seem to be jurisdiction over a suit for damages . . . ." IIT v. Vencap, Ltd., supra, 519 F. 2d at 1018.

foreigners, "this basis of jurisdiction is limited to the perpetration of fraudulent acts themselves and does not extend to mere preparatory activities." [Vencap, supra, 519 F. 2d at 1018; see Bersch, supra, 519 F. 2d at 987). 81/ All three of these theories are applicable to this case: (1) Lipper, an American citizen, was the president of an American firm registered with the Commission and based in New York City; (2) because of FOF's 3,000 American shareholders, petitioners' conduct had substantial consequences in the United States; and (3) all of the steps by which the IOS/Lipper scheme was consummated were performed in the United States -- the securities transactions in which Lipper Corp. engaged on behalf of the IOS funds were executed in the American securities markets, and the unlawful give-up payments, the act by which an IOS subsidiary received monies which originated with the funds, occurred in New York City.

Thus, the conduct which lead the Commission to institute this proceeding and for which petitioners were sanctioned, occurred exclusively in the United States and involved transactions in American securities on the

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81/ In Bersch, this Court held that the antifraud provisions of the federal securities laws could be invoked under theory (2) by American purchasers of IOS's common stock regardless of where the fraudulent acts occurred, and by nonresident Americans if acts of material importance in the United States contributed to their losses; foreign purchasers of IOS shares were, however, not within the protection of federal law unless, under theory (3), acts within the United States had directly caused their losses. 519 F. 2d at 993.

In Vencap, an action by IIT for alleged violations of the federal securities laws in connection with its own investment in Vencap, the Court found it necessary to remand the case to the district for further findings regarding theory (3). 519 F. 2d at 1018-19. On remand, the district court held that Vencap's acts in the United States were not merely preparatory but were sufficiently proximate to IIT's losses to sustain subject matter jurisdiction. IIT v. Vencap, Ltd., CCH Fed. Sec. L. Rep. ¶95,398 (S.D.N.Y., Dec. 4, 1975).

American markets -- precisely the subject over which Congress has given the Commission regulatory authority. 82/ Similarly, in Straub v. Vaisman and Company, Inc., CCH Fed. Sec. L. Rep. ¶95,623 (C.A. 3, June 15, 1976), a German customer of a registered American broker-dealer brought suit against the firm alleging fraud in connection with securities purchases executed by the broker-dealer on the basis of instructions transmitted from Germany. The court stated that "[c]onduct within the United States is alone sufficient from a jurisdictional standpoint to apply the federal statutes. . . ." ¶95,623 at p. 90,108. The court noted that application of the securities laws was warranted because the "fraudulent scheme was conceived in the United States by American citizens," the scheme involved stock in "an American corporation traded on American over-the-counter exchange," and the entity responsible was "an American securities broker from his office in New Jersey." Id. 83/ Each of these factors is also present in the instant case. The court concluded, "Moreover, on policy grounds the interest

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82/ For this reason, petitioners' discussion of the law of fiduciary responsibility in Europe (Pet. Br. 46) is not relevant to any issue in this appeal. See Section 17(a) of the Restatement (2d) of the Foreign Relations Law of the United States, supra, p. 54-55 n. 75.

Likewise, petitioners' hypothetical involving a sale between foreign parties which utilizes the United States jurisdictional means (Pet. Br. 45), is inapposite. In the present case, it was not a German bank but an American broker-dealer which engaged in the fraudulent scheme, and the unreasonable charge occurred not in Germany but in the United States. The kickback went to IPC, another American broker-dealer, not to a German bank.

83/ F.O.F. Proprietary Funds, Inc. v. Arthur Young & Co., 400 F. Supp. 1219 (S.D.N.Y., 1975), the district court case on which petitioners

(footnote continued)

of the United States in regulating the conduct of its broker-dealers in this country and enhancing world confidence in its securities markets is ample justification for applying the securities laws." Id.[84/]

B. The Commission Has Authority To Increase An Administrative Law Judge's Recommended Sanctions And Did Not Abuse Its Discretion In Doing So In This Proceeding

The Commission found it "incompatible with the public interest" (Doc. 358, R. 3870, n. 72, A. 453) for petitioners to continue in the securities business, and accordingly, barred Mr. Lipper from association with any broker-dealer, and revoked Lipper Corp.'s registration as a broker-dealer.[85/] Petitioners argue (Pet. Br. 52) that, by rejecting the more lenient sanctions which the administrative law judge had recommended, the Commission denied

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83/ (footnote continued)

place primary reliance (Pet. Br. 49-51), is not to the contrary. In that case, a private damage action, not a Commission administrative proceeding against one of its registrants, the court found that, as a factual matter, the only acts involved in the alleged fraud perpetrated on FOF Prop. which occurred in the United States were "acts in preparation of the fraud." 400 F. Supp. at 1223. The case did not involve, as does the present one, the defrauding of FOF Prop. by means of payments between two American broker-dealers, in the United States, of monies arising from commissions charged for transactions in the American securities markets.

84/ Accord Travis v. Anthes Imperial Ltd., 473 F. 2d 515, 524 (C.A. 8, 1973); and Leasco Data Processing Equipment Corp. v. Maxwell, 468 F. 2d 1326, 1339 (C.A. 2, 1972).

85/ Petitioners refer to this bar as being "for life" (Pet. Br. 2). As this Court noted in the context of a similar assault on a Commission administrative sanction,

> "the permanent bar order which the Commission in its discretion has imposed . . . is not necessarily an irrevocable sanction; upon application, the Commission, if it finds that the public interest no longer requires

(footnote continued)

them due process. 86/ This Court has repeatedly held that the "Commission clearly has the authority to modify, including the authority to increase, sanctions ordered by a hearing examiner in his initial decision." Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 599 (C.A. 2, 1969). 87/ As this Court then noted, both Section 8(a) of the Administrative Procedure Act, 5 U.S.C. 557(b), and Rule 17(g)(2)

85/ (footnote continued)

> the applicant's exclusion from the securities business, may permit his return -- usually subject to appropriate safeguards." Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 598 (C.A. 2, 1969).

See Securities and Exchange Act Rule 15Ab-1, 17 CFR 240. 15Ab-1.

86/ The administrative law judge would have suspended Lipper Corp. from effecting over-the-counter transactions for 12 months and barred Lipper from association with any broker or dealer for the same period (Doc. 286, R. 3077, A. 422).

Petitioners also imply (Pet. Br. 32) that the Commission's conclusion that they aided and abetted IOS's violations differs in that respect from that of the administrative law judge. In fact, however, the initial decision expressly states that petitioners "willfully aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder." (Doc. 286, R. 3067, A. 412.) Regarding aiding and abetting, "an offense for which . . . [a person] properly may be disciplined pursuant to Section 15(b)(5)(E) and (7) of the Securities Exchange Act," see this Court's decision in Gross v. Securities and Exchange Commission, 418 F. 2d 103, 106 (C.A. 2, 1969).

87/ See also, Hiller v. Securities and Exchange Commission, 429 F. 2d 856,858 (C.A. 2, 1970); Fink v. Securities and Exchange Commission, 417 F. 2d 1058, 1059-60 (C.A. 2, 1969); and Gross v. Securities and Exchange Commission, supra, 418 F. 2d at 107. Other courts of appeal have likewise held that the Commission may increase the sanctions recommended by its administrative law judge. See O'Leary v. Securities and Exchange Commission, 424 F. 2d 908, 912 (C.A.D.C., 1970); and Nees v. Securities and Exchange

of the Commission's Rules of Pracrice, 17 CFR 201.17(g)(2), confer plenary authority on the agency to modify initial decisions of its hearing officers.

The question of the appropriate sanctions which the public interest requires to redress willful violations of the federal securities laws "'is peculiarly a matter for administrative competence.' . . . [O]nly if the remedy chosen is unwarranted in law or is without justification in fact should a court attempt to intervene in the matter." American Power & Light Co. v. Securities and Exchange Commission, 329 U.S. 90, 112-13 (1946); see also Securities and Exchange Commission v. Chenery Corp., 332 U.S. 194, 207-08 (1947).88/ And it is well settled that, in the absence of gross abuse of discretion, the courts will not disturb a Commission order imposing remedial sanctions.89/

87/ (footnote continued

Commission, 414 F. 2d 211, 217 (C.A. 9, 1969). It is the Commission, not the administrative law judge, which Congress has entrusted with the ultimate responsibility and discretion to determine what sanctions are appropriate in the public interest in cases involving violations of the federal securities laws. See generally Consolo v. Federal Maritime Commission, 383 U.S. 607, 620-21 (1966); and Pierce v. Securities and Exchange Commission, 239 F. 2d 160, 163-64 (C.A. 9, 1956).

88/ Other holdings emphasizing the Commission's broad discretion to determine the appropriate sanctions for violating the Securities Exchange Act include: Berko v. Securities and Exchange Commission, 316 F. 2d 137, 141-42 (C.A. 2, 1963); Bourski v. Securities and Exchange Commission, 289 F. 2d 738 (C.A. 2, 1961); Wright v. Securities and Exchange Commission, 112 F. 2d 89, 94-95 (C.A. 2, 1940); see also, Nassau Securities Service v. Securities and Exchange Commission, 348 F. 2d 133, 136 (C.A. 2, 1965); Pierce v. Securities and Exchange Commission, supra, 239 F. 2d at 163-64; San Francisco Mining Exchange v. Securities and Exchange Commission, 378 F. 2d 162 (C.A. 9, 1967).

89/ Sinclair v. Securities and Exchange Commission, supra, 444 F. 2d at 402; Gross v. Securities and Exchange Commission, supra, 418 F. 2d at 107-08; Fink v. Securities and Exchange Commission, supra,

(footnote continued)

In the present case, the Commission's decision to impose greater sanctions than those recommended in the initial decision was well within its discretion. As stated above (p. 5), the administrative law judge had found that Mr. Lipper did "nothing to ameliorate [the] fraudulent practice until his own . . . financial success [was] assured," and that he was "a man intent on personal gain" and willing to gamble on the legality of his means to that goal (Doc. 286, R. 3075-76, A. 420-21). 90/ The Commission adopted this finding and also noted that:

> "In the situations of this sort, the remitting broker and the receiving institutional manager are acting _in pari delicto_. Neither can accomplish his ends without the other. We cannot be as sanguine as the administrative law judge about future derelictions of this sort by the Lipper respondents. What we have before us is not some isolated indiscretion. Lipper Corp. owed its existence to IOS. And the Lipper-IOS relationship was rooted in the over-the-counter give-ups that flowed from Lipper to IPC." (Doc. 358, R. 3870, A. 453)

89/ (footnote continued)

417 F. 2d at 1060; _Vanasco_ v. _Securities and Exchange Commission_, 395 F. 2d 349, 352-53 (C.A. 2, 1968); see also _Quinn & Co._ v. _Securities and Exchange Commission_, 452 F. 2d 943, 947 (C.A. 10, 1971), _certiorari denied_, 406 U.S. 957 (1972); _O'Leary_ v. _Securities and Exchange Commission_, _supra_, 424 F. 2d at 912; _Armstrong-Jones & Co._ v. _Securities and Exchange Commission_, 421 F. 2d 359, 365 (C.A. 6), _certiorari denied_, 398 U.S. 958 (1970); _Nees_ v. _Securities and Exchange Commission_, _supra_, 414 F. 2d at 217.

90/ Considering Mr. Lipper's efforts at self-enrichment, petitioners state (Pet. Br. 53) that "neither Arthur Lipper Corporation nor Mr. Lipper kept one penny of the monies alleged to have been 'diverted' to IPC." It is, of course, a truism that that portion of the excessive charges which petitioners kicked back to IPC they did not retain.

From these facts, the Commission was fully supported in its conclusion that "the likelihood of future misconduct by the Lipper respondents [is] sufficient to call for their exclusion from the securities business." (Id.) 91/

Petitioners imply (Pet. Br. 54) that, in light of current industry conditions, they would not again choose to engage in the practice of commission sharing if permitted to continue in business. In drawing the inference that petitioners' past conduct indicated an unacceptable risk of future violations, the Commission was, however, not required to assume that the only risk was repetition of the identical violations:

> "The Commission must have a very large measure of discretion in determining what sanctions to impose at a particular time in particular cases. Failing a gross abuse of discretion, the courts should not attempt to impose their untutored views as to what sanctions will best accord the regulatory powers of the Commission." Tager v. Securities and Exchange Commission, 344 F. 2d 5, 9 (C.A. 2, 1965). 92/

91/ The Commission, in selecting the appropriate sanctions, also considered as a factor its responsibility to deter other broker-dealers from choosing to participate "in the fraudulent schemes concocted by investment company managers." Doc. 358, R. 3870, A. 453.

92/ Accord, Hughes v. Securities and Exchange Commission, supra, 174 F. 2d at 975.

Petitioners also complain (Pet. Br. 54) that the sanctions which the Commission imposed constituted "punishment." On the contrary, however, "[t]he Commission's order is not punitive . . . [r]evocation and denial of registration are but means to protect the public interest." Blaise D'Antoni & Associates, Inc. v. Securities and Exchange Commission, 289 F. 2d 276, 277, rehearing denied, 290 F. 2d 688 (C.A. 5), certiorari denied, 368 U.S. 899 (1961).

C. The Commission's Findings Are Supported By Substantial Evidence In The Record

The evidence supporting the Commission's findings has been described in detail (pp. 8-20, 35-37, supra). In responding to the Commission's order instituting proceedings against them, petitioners admitted that they paid give-ups to IPC in connection with the IOS funds' over-the-counter transactions (Doc. 214, R. 2593), and, in any event, the uncontradicted evidence established that $1.4 million of these payments had been made. Thus, petitioners' arguments are without merit. 93/

D. The Commission Did Not Abuse Its Discretion In Adhering To Rule 21(f) Of Its Rules Of Practice And Declining To Grant Petitioners' Request For A Second Opportunity To Argue Their Case Before The Commission

Petitioners' counsel presented oral argument to the Commission on August 28, 1972. This argument was transcribed verbatim, and the transcript, 58 pages in length, was made a part of the record (Doc. 2, R. 1589-1646). Commissioners Owens, Herlong, and Loomis were present at the argument; Chairman Casey was absent, and there was one

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93/ Petitioners argue that the Exchange's lack of authority to set minimum rates was shown only through "staff studies" (Pet. Br. 34). We believe that Commission reports, issued prior to the commencement of this proceeding, could have been utilized to demonstrate the Exchange's lack of authority in the over-the-counter market. However, as described above (pps. 35-37, supra), the Commission did not rely exclusively on those studies but also on the testimony of Mr. Bishop, the responsible Exchange official, to establish that the Exchange had no requirement that the minimum commission rate be charged for over-the-counter business.

Petitioners also contend that the Commission ignored evidence that "there was no way in which Arthur Lipper Corporation could have justified to the NYSE charging a lower commission rate from a cost standpoint" (Pet Br. 35). As described previously (pp. 36-37, supra), the evidence established that Lipper Corp. was able to pay IPC 50 percent of the commission charged IOS funds and still made an "exorbitant" profit; that Lipper Corp. charged other investment companies no commission at all during part of

(footnote continued)

vacancy on the Commission. The Commission rendered its opinion on October 24, 1975; 93/ Chairman Garrett and Commissioners Loomis, Evans, and

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93/ (footnote continued)

the time it was charging IOS funds the Exchange minimum commission; and that, as soon as give-ups were abolished, Lipper Corp. dropped its charges to a flat six cents per share and submitted evidence to the Exchange justifying that that rate still permitted it to cover its costs.

Thus, petitioners' contention that there is a lack of evidentiary support for the Commission's findings simply ignores the record in this case.

94/ Petitioners state that decision followed argument by three years for "unexplained reasons" (Pet Br. 54). In this connection, the Commission noted in its opinion:

> "[S]ome years have now elapsed since [petitioners] were last engaged in the securities business. That obviated any need for speedy action by us. However, . . . [petitioners] are [i.e., prior to the Commission's order] still legally free to engage in the securities business. Since we believe that this would be incompatible with the public interst, we are constrained to take appropriate preventive action" (Doc. 358, R. 3870, n. 72, A. 453).

It should also be noted that petitioners were not subject to any sanction during the period of Commission consideration of their case. Rule 17(f) of the Commission's Rules of Practice, 17 CFR 201.17(f), provides that, where a petition for review by the Commission is filed, an administrative law judge's initial decision does not become final as to that party.

In similar circumstances, the Ninth Circuit has held that delay of several years in a Commission proceeding to revoke a broker-dealer's registration did not constitute a denial of due process:

> "[Petitioner] did not contest the Commission's delay until the Commission moved . . . to reconvene the hearing. He could have earlier petitioned a court to compel the Commission to expedite its proceedings. . . . But he might have been expediting the demise of his business . . . . [Petitioner], like the litigant who complained before the United States Supreme Court of the NLRB's delaying two and a half years before enforcing one of its orders, . . . ' is hardly in a position to object.'" Irish v. Securities and Exchange Commission, 367 F. 2d 637, 639 (C.A. 9, 1966), certiorari denied, 386 U.S. 911 (1967).

Sommer joined in the unanimous decision. Commissioner Pollack did not participate.

Throughout the period that this case was pending, petitioners never offered or requested to reargue on grounds of intervening changes in the Commission's membership. When, however, they learned that the Commission's decision was adverse to them, petitioners then moved for rehearing on the theory that they had been denied "a de facto oral argument" (Doc. 360, R. 3875, 3880). This motion rested solely on the fact that the Commissioners deciding the case were not identical to those who had heard the argument; petitioners did not identify any specific source of prejudice which resulted from the changes in Commission membership, nor did their motion even state that the Commission's decision was in any way erroneous or ask that it be altered upon reconsideration (Doc. 360, R. 3875-81). On January 6, 1976, the Commission, by order, denied rehearing (Doc. 364, R. 3906-08, A. 456-58).

Although petitioners allude (Pet. Br. 3-4, 53-54) to their contention that the failure to grant rehearing denied them due process, and have expressly appealed from the January 6, 1976, order, they have apparently now abandoned this claim.[95/] Nevertheless, it should be noted that the Commission's denial of the petition for rehearing was in full accord with both its own rules and the requirements of due process.

Rule 21(f) of the Commission's Rules of Practice, 17 CFR 201.21(f), provides:

> "Any member or members of the Commission who were not present at the oral argument may participate in the

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95/ "Petitioners do not urge this Court, however, to remand this case for oral argument because petitioners believe this would simply prolong the extended ordeal already suffered" (Pet. Br. 54).

> decision of the proceeding. Any Commissioner participating in the decision who was not present at oral argument will reveiw the transcript of such argument."

Rule 21(f), which was adopted in 1966, is a codification of longstanding agency practice. 96/ This practice had received judicial approval the prior year in Gearhart & Otis, Inc. v. Securities and Exchange Commission, 348 F. 2d 798 (C.A.D.C., 1965). In Gearhart, the petitioners challenged revocation of a broker-dealer's registration on the grounds, *inter alia*, of a change in Commission membership between oral argument and decision. Although the court rejected this argument on the ground that counsel had acquiesced in the practice later codified in Rule 21(f) at oral argument, the court of appeals stated:

> "The decisions of numerous courts and administrative agencies establish that . . . a member of an administrative agency who did not hear oral argument may nevertheless participate in the decision where he has the benefit of the record before him. Indeed, with respect to judges assigned to a panel, such is the practice of this court." 348 F. 2d at 802 (footnotes omitted). 97/

96/ For example, in Isthmus Steamship & Salvage Co., Inc., 42 SEC 465 (1964), rehearing was requested on the ground that one of the members participating in a three-member decision had not been a member of the Commission at the time of argument. The Commission rejected this motion, stating

> "it has been normal practice for Commissioners becoming such after oral arguments in various cases to participate in the decisions in those cases, following their reading of the transcript of the oral argument, which is recorded by an official stenographer." 42 SEC at 466.

97/ See Eastland Co. v. Federal Communications Commission, 92 F. 2d 467, 469-70 (C.A. D.C.), *certiorari denied*, 302 U.S. 735 (1937) (change of two of three members of division of Commission deciding case).

(footnote continued)

As the ample body of judicial precedents establishes, due process does not require that all deciding Commissioners be present at oral argument, particularly where credibility and demeanor are not at issue. 98/

CONCLUSION

For the foregoing reasons, the orders of the Securities and Exchange Commission should be affirmed.

Respectfully submitted,

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Dated: August, 1976

98/ Indeed, oral argument itself is not mandatory in agency proceedings. See Federal Communications Commission v. WJR, 337 U.S. 265, 275-76 (1949). Similarly, it is well-established that oral argument is not constitutionally required even in federal judicial proceedings. See, e.g., National Labor Relations Board v. Local No. 42, Int'l. Ass'n. of Heat and Frost Insulators and Asbestos Workers, 476 F. 2d 275, 276 (C.A. 3, 1973); Securities and Exchange Commission v. MacElvain, 417 F. 2d 1134, 1135 (C.A. 5, 1969), certiorari denied, 397 U.S. 972 (1970); In re Amendment of Rule 3, 440 F. 2d 847 (C.A. 9, 1970). Cf. Rule 78, Federal Rules of Civil Procedure; Rule 34, Federal Rules of Appellate Procedure; and 9 Moore's Federal Practice, §234.02 (1975).